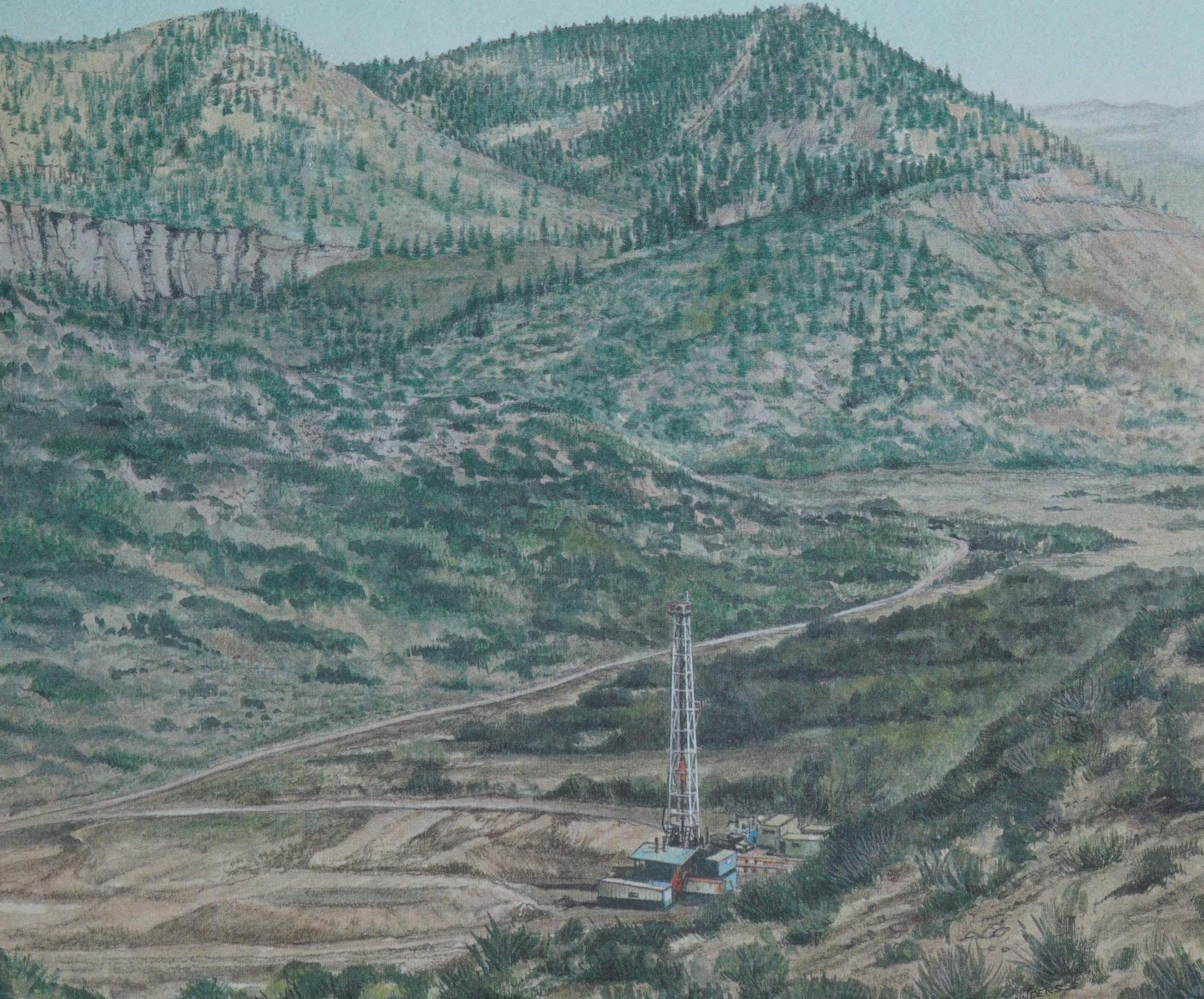
Canadian Merrill Ltd.

annual report 1977

49.2% HELD BY
Hudson Bay Mining and Smelting Co. LTD



Canadian Merrill Ltd.

Incorporated Under the Laws of the Province of Quebec

DIRECTORS

ROBIN J. ABERCROMBIE,
Calgary, Alberta
Senior Vice-President of the Alberta Gas Trunk Line Company Limited

ROBERT S. BLACKETT
Calgary, Alberta
Executive Vice-President of the Company

JOHN L. CARPENTER
Toronto, Ontario
Executive Vice-President of Hudson Bay Mining and Smelting Co., Limited

KENNETH S. DALTON,
Toronto, Ontario
Vice-President, Finance of Hudson Bay Mining and Smelting Co., Limited

ADRIAN M. DOULL,
Toronto, Ontario
Senior Vice-President, Finance of Hudson Bay Mining and Smelting Co., Limited

HORACE REKUNYK,
Calgary, Alberta
Chairman of the Board and President of the Company

C. KEITH TAYLOR, Q.C.
Toronto, Ontario
Senior Vice-President, Administration, Secretary and General Counsel of Hudson Bay Mining and Smelting Co., Limited

JAMES M. THOMSON, Q.C.,
Calgary, Alberta
Associate in Milner & Steer

OFFICERS

HORACE REKUNYK,
Chairman of the Board and President

ROBERT S. BLACKETT
Executive Vice-President

CHARLES W. TEMPLETON
Senior Vice-President, Exploration

ROBERT F. GILMOUR
Vice-President, Production and Engineering

G. BARRY PADLEY, C.A.
Vice-President, Finance and Treasurer

WILLIAM C. MILLS
Secretary

JAMES N. WILLIAMS, C.A.
Assistant Treasurer

LUCILLE BRIMACOMBE
Comptroller

Cover Painting — Merrill's Young 3-28 well drilling in the Rock Canyon area, Colorado.

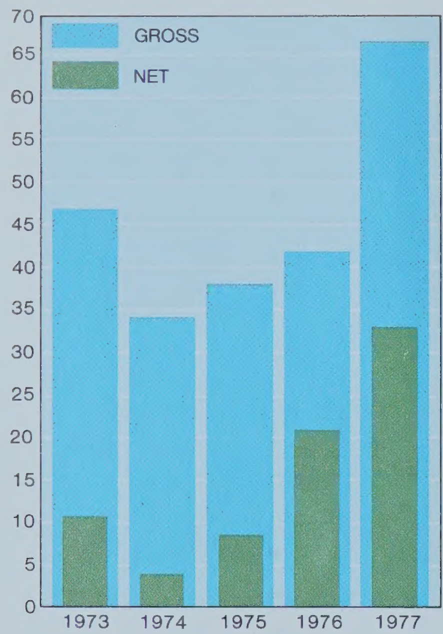
The 26th Annual Report to June 30, 1977

Comparative Highlights

	1977	1976	Increase Per Cent
Financial			
Revenue by source:			
Oil and gas production	$16,181,000	$10,382,000	55.9
Interest and other income	150,000	170,000	(12.0)
Gross revenue	16,331,000	10,552,000	54.8
Cash flow from oil and gas operations	6,120,000	3,550,000	72.4
Per share	2.95	1.76	
Income from continuing oil and gas operations	2,932,000	1,693,000	73.2
Per share	1.42	.84	
Income (Loss) from discontinued operations	—	(296,000)	—
Net income for the year	3,555,000	1,987,000	78.9
Per share	1.72	.99	
Capital expenditures	11,246,000	6,447,000	74.4
Working capital deficiency	(2,460,000)	(907,000)	171.2
Total assets	40,256,000	28,823,000	39.7
Shares outstanding	2,073,870	2,013,920	3.0
Operating			
Natural gas production, net before royalties:			
Total — million cubic feet	11,821	9,512	24.3
Daily average — million cubic feet	32.4	26.0	
Oil production, net before royalties:			
Total — barrels	240,875	224,831	7.1
Daily average — barrels	660	614	
Number of net productive wells:			
Gas	120.3	107.3	12.1
Oil	64.9	59.9	8.3
Acreage holdings:			
Gross	804,730	879,540	(8.5)
Net	394,249	438,566	(10.1)

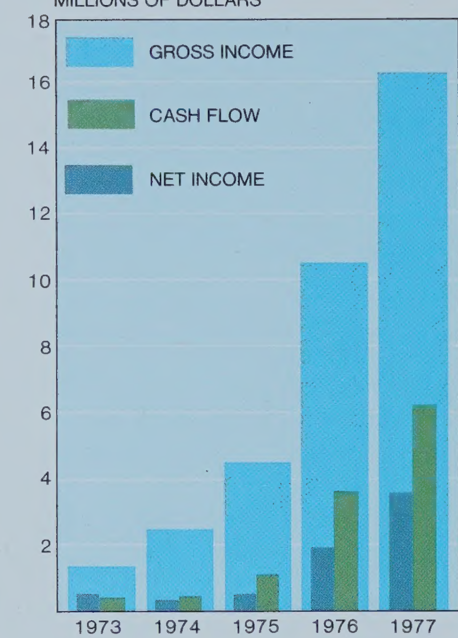
Report to

WELLS DRILLED



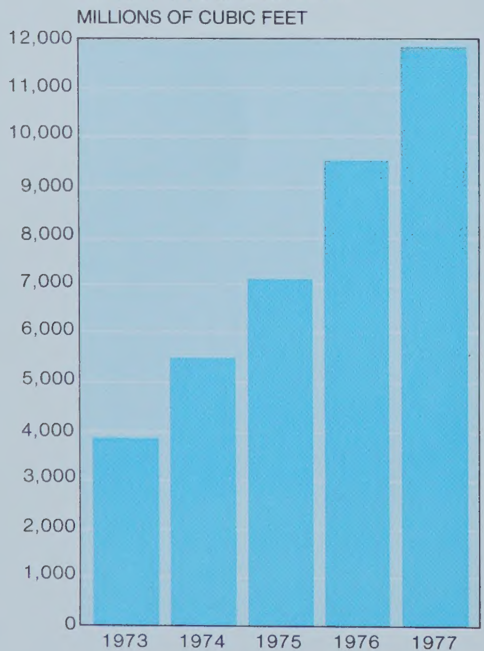
FINANCIAL

MILLIONS OF DOLLARS



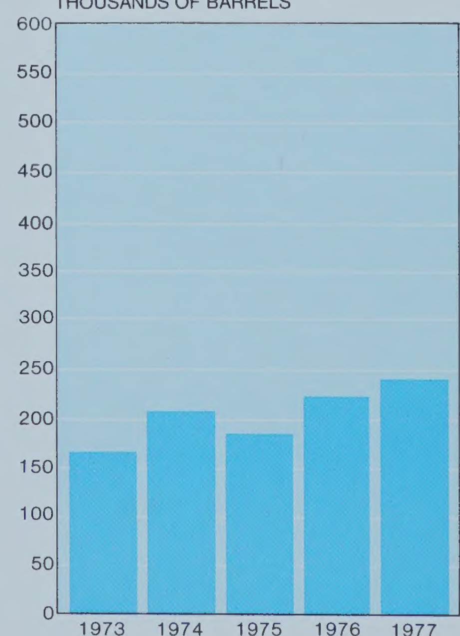
GAS PRODUCTION

MILLIONS OF CUBIC FEET



OIL PRODUCTION

THOUSANDS OF BARRELS



The Company's operations during the fiscal year ended June 30, 1977 continued to show positive results.

— Natural gas production before royalties increased by 24% to an average rate of 32.4 million cubic feet per day (MMcf/d). At year-end, gas production rates reached 39.5 MMcf/d.

— Oil production increased 7% to an average rate of 660 barrels per day.

— Gross production revenues reached a record level of $16,181,000.

— The Company's aggressive exploration and development drilling program resulted in a total of 67 wells (33 net) being completed on Company properties.

— The Company's wells drilled in the 1976/77 program in the Rock Canyon area, Colorado, were approaching an on-production status at year-end. Substantial additions to the Company's gas reserves were established by this program.

Financial Highlights.

Gross revenue from oil and gas operations was $16,181,000, up 55% from the $10,382,000 recorded in 1976. This reflects increased gas production in Canada and the United States and higher oil and gas selling prices in both countries. Pre-tax cash flow from continuing operations was $6,120,000, or $2.95 per share, an increase of 72% from $3,550,000, or $1.76 per share, in 1976. Net income for the year, including extraordinary

Shareholders

items, was $3,555,000, or $1.72 per share, up 79% from $1,987,000, or 99¢ per share, in 1976. Over the past five-year period, revenue from oil and gas operations, pre-tax cash flow from operations and net income have all grown substantially and shown cumulative increases of approximately 1,000%, 1,400% and 600%, respectively.

The Company's expanded exploration and development drilling programs and land acquisitions reflect Merrill's increased activity in Alberta and Colorado. Merrill's 1977 drilling program increased to 67 gross wells (33.0 net) from 42 gross wells (20.7 net) in 1976. Capital expenditures in 1977 amounted to $11,246,000 compared to $6,277,000 in 1976. Approximately 65% of the fiscal 1977 expenditures was spent in western Canada and 35% in Colorado. The Company's working capital deficiency increased to $2,460,000 from $907,000 in 1976, mainly because full production revenues have not yet been realized from recent capital expenditures in Colorado and curtailments of gas sales in Alberta. Consequently, the long-term debt position increased to $13,847,000 as of June 30, 1977, up $2,402,000 from the prior year-end.

Exploration Activities

The Company drilled or participated in 19 gross (9.75 net) exploratory wells in fiscal 1977. Of the net wells, 6.1 were completed or indicated gas wells, 1.3 were completed or indicated oil wells and 2.4 wells were abandoned. The overall success ratio was 68%.

The Company's gross and net acreage holdings dropped slightly from June 30, 1976 to June 30, 1977. This was the net result of the disposition of maturing acreage in Alberta and offshore east coast that was partially offset by promising acquisitions in western Saskatchewan, northeastern British Columbia and selective acquisitions in Alberta. In July and August 1977 some highly promising lands totalling 25,964 gross and 13,143 net acres were purchased in Alberta and British Columbia.

In Canada, the Company participated in natural gas discoveries in the Sunnynook, Vermilion and Valleyview areas of Alberta and the Siphon area of British Columbia. Oil discoveries were made on Merrill acreage in the Princess and Stanmore areas of Alberta and the Fox area of British Columbia.

In the United States, the Company's drilling efforts were largely directed to the Rock Canyon area of Colorado, where eight gas wells were completed and where reserves have been materially increased. Wells in this area encounter gas in a number of different sands at depths varying from 3,000 to 8,000 feet. This drilling program will proceed throughout the summer and fall of 1977.

The Company is conducting an exploration program on its Antoinette Lake claims located near Chibougamau, Quebec. Interesting assays of zinc, silver and gold ore have been received but further core drilling will be required to establish the extent of the ore body. The claims are approximately six miles from the Company's mothballed milling facility.

Producing Operations

The Company drilled 48 gross (23.2 net) development wells in 1977. This program resulted in 13.2 net gas wells, 3.8 net oil wells and 6.2 net abandonments. The overall success ratio was 81%.

The Company's natural gas production, before royalties, was 11.8 billion cubic feet, an average of 32.4 million cubic feet per day, an increase of 24% over 1976. This increase was achieved despite curtailments by the major gas purchaser in Alberta due to a market over-supply situation. The Company's crude oil production increased 7% over the year. Merrill's natural gas reserves as of June 30, 1977 showed a material improvement over the prior year after having accounted for this year's production.

Corporate

Hudson Bay Mining and Smelting Co., Limited increased its common share equity interest in the Company to 49.2% through the purchase of shares on the open market. Hudson Bay also holds a 6½% Secured Convertible Income Debenture convertible to 666,667 common shares. The conversion of this debenture would increase Hudson Bay's holdings to 61.3% of Merrill's outstanding common shares. The Company has given notice to Hudson Bay of its intention to redeem this debenture effective November 1,

1977. Hudson Bay has not yet indicated if it intends to exercise its right of conversion before the redemption date.

Mr. Robert S. Blackett was appointed Executive Vice-President of the Company in April and appointed to the Board of Directors in May. The Board of Directors accepted, with regret, the resignation of Mr. V. Lyle Hawkes in May, 1977, and in addition has been advised by Mr. Kenneth S. Dalton that he will not be standing for re-election due to other business commitments. The Board wishes to acknowledge the valuable contributions to the Company made by each of these Directors. The Board is also pleased to announce that Mr. E. Peter Gush, President of Hudson Bay Mining and Smelting Co., Limited will be nominated to the Company's Board of Directors.

Your Directors have voted to change the Company's fiscal year-end from June 30 to December 31 starting with the year ended December 31, 1977. This resolution is included in the enclosed proxy material and will be adopted by the Company if approval is received from the shareholders at the forthcoming annual meeting.

The oil and gas industry in Canada and the United States is buoyant and management believes many worth-while opportunities exist in the exploration and producing sectors. The Company plans to dedicate technical and financial resources in the coming fiscal period to expand its exploration activities in the three western Canadian provinces. Additionally, the Company will proceed with development drilling in the promising Rock Canyon area of Colorado and selected projects in western Canada.

The natural gas producing sector in Alberta has been adversely affected in recent months by gas purchaser curtailments due to an over-supply condition in the market place. This is the so-called "gas bubble" which, according to management and industry experts, will prevail to some degree for two to four years. Nevertheless, Merrill's forecast of gas sales in the immediate future will show increases which, combined with announced price increases, will result in improved revenues. Merrill's sources of increasing gas production in Alberta are mostly related to existing operations. It is expected that new Alberta sources will not have access to markets until at least late in 1979. Therefore, the past growth rate in Merrill's gas sales is expected to moderate for the balance of 1977 and particularly in 1978. By way of contrast, the Rock Canyon, Colorado, properties will have immediate access to markets dependent primarily on the rate of drilling and pipeline construction.

Your Directors wish to express their thanks to the employees of Canadian Merrill for their contributions to the success and growth of the Company and for a job well done. The business environment for the oil and gas industry is very promising but it is only through dedicated employees that the Company can successfully participate to its fullest advantage.

Respectfully submitted on behalf of the Board of Directors,

H. ReKunyk
Chairman of the Board

September, 28, 1977

Operations

Exploration and Development

ALBERTA

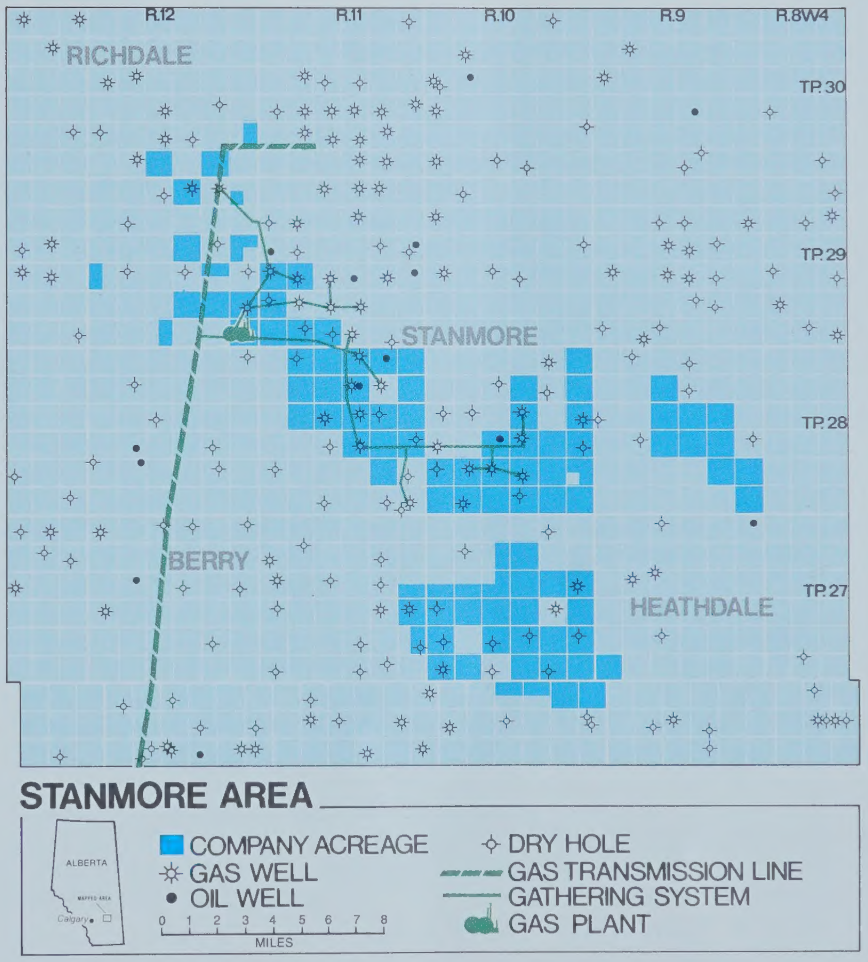
The Company continued to expand its drilling and production efforts in the Stanmore area of eastern Alberta. The Company participated in drilling five wells in the area, of which three tested gas from two producing zones and one was a single zone gas producer. Oil was also discovered in one of the dual zone gas wells. Further drilling is planned to develop this oil discovery. Two gas wells and three dry holes were drilled by another company on a 5,760 acre farmout from Merrill. The Company retained an overriding royalty interest in the five sections drilled on and a 50% working interest on the remaining lands. Further drilling will be undertaken in the area of the two gas discoveries.

As a result of higher demand for gas in the Stanmore area, the Company has planned a detailed seismic program over its other wholly-owned acreage.

In the Birch Lake gas producing area, Merrill participated in the drilling of eight wells, six of which were completed as gas wells. Additional drilling will be undertaken in 1977.

In the Princess area, four wells were drilled on Company acreage, resulting in three oil wells and one dry hole.

Fifteen development wells were drilled and completed as Milk River gas wells in the Medicine Hat area. The Company has a 9% interest in these wells.

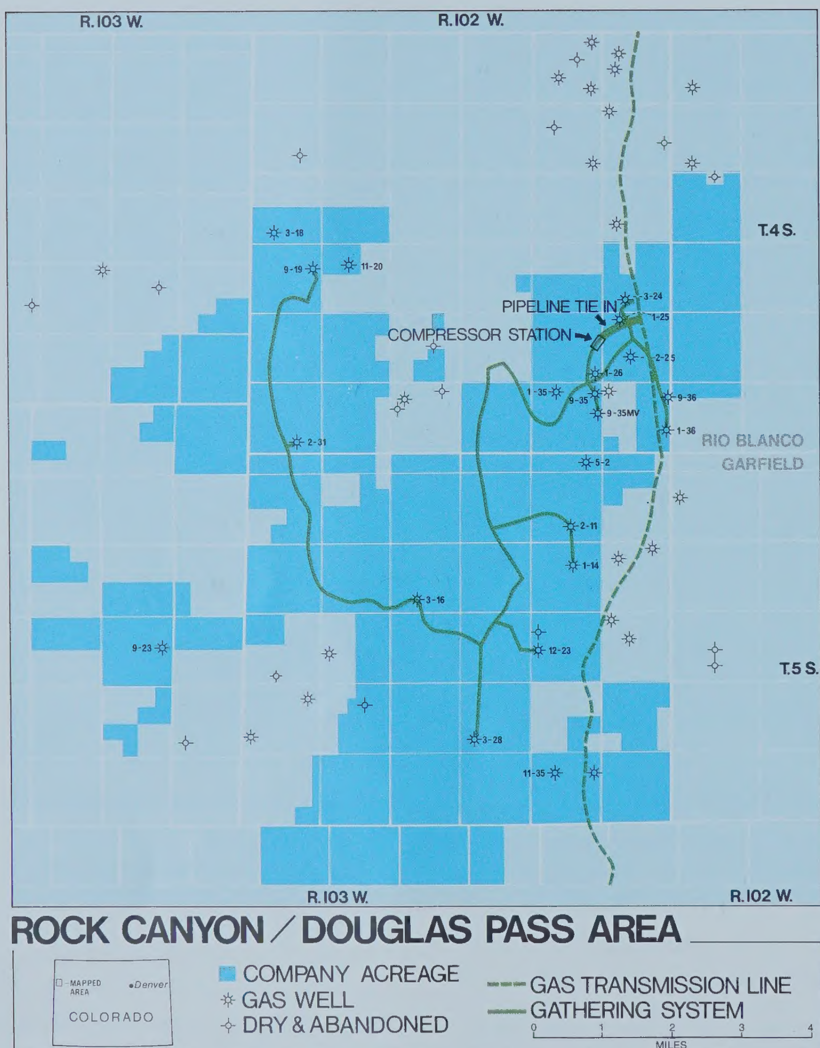


In other areas of Alberta, gas wells were completed at Sunnynook (100% interest), Oyen (92%), Vermilion (100%), Hairy Hills (25%) and Valleyview (100%).

BRITISH COLUMBIA

In the Fox area, a discovery well was drilled offsetting an earlier non-commercial oil show. The new discovery well, Pacific Provident Fox d-60-D (32% interest) proved to be oil-productive in the Baldonnel formation. This well was production tested during the summer and further drilling is planned to evaluate this discovery later this year.

The Company also participated in drilling a discovery gas well in the Siphon area. Initial production testing of this well gave up gas and oil. Due to weather and road conditions, testing was not completed and will be resumed next winter.



ROCK CANYON / DOUGLAS PASS AREA

COLORADO

Canadian Merrill, through its wholly-owned subsidiary, Provident Resources, Inc., drilled eight gas wells in the Rock Canyon area of Colorado. Seven of these wells are wholly-owned and the Company has a 25% interest in the eighth. Four of the wells were drilled to test the Mancos sand only and each of these indicated production from that zone.

One of these four wells also indicated a thick series of shallower gas-bearing zones in the Mesa Verde formation. Another well will be drilled to production test these sands. The Mancos sand was also gas-productive in the four deeper tests. In addition to the Mancos, these four wells also have gas-bearing Dakota sands and two of them flowed gas from the Buckhorn sandstone.

The wells drilled on the above program were perforated and production-tested during the past summer and will be placed on production as pipeline facilities are completed. It is expected that at least 15 of the Company's gas wells will be on production in the fall of 1977.

A drilling program involving 10 to 15 additional wells will be undertaken during the next fiscal year to further develop the Company's undrilled acreage in the Rock Canyon area.

Production Operations

Merrill and its subsidiaries held interests in 213 gross gas wells (120.3 net gas wells) and 376 gross oil wells (64.9 net oil wells) at year-end. The Company's producing properties are located primarily in the Province of Alberta and the States of Colorado, Montana and Wyoming.

Merrill's gas production, before royalties, increased 24% in 1977 to 11,821 million cubic feet (32.4 million cubic feet per day) from 9,512 million cubic feet (26.0 million cubic feet per day) last year. This increase was achieved despite the adverse impact of cut-backs due to a reduction in take by the major gas purchaser related to an over supply condition in the market place.

In Alberta, Merrill expanded the gas gathering and processing facilities in the Stanmore field during the past year. The expanded facilities went on production during April, 1977 so that the full effect of this increased production will not be felt until fiscal 1978. A significant increase in the Company's United States gas production is anticipated in 1978 as a result of the drilling carried out on its acreage in the Rock Canyon area, Colorado.

The Company's oil production, before royalties, increased 7% to 240,875 barrels (660 barrels per day) from 224,831 barrels (614 barrels per day) in 1976.

In the year ended June 30, 1977, the average gas price received by Merrill for Canadian gas sales was $1.16 per thousand cubic feet (Mcf) compared with 86.7¢ in the previous year. Merrill's average oil price was $9.09 per barrel in the past year compared with $8.64 per barrel in 1976.

In western Canada, the wellhead price of natural gas increased to approximately $1.31 per Mcf on August 1, 1977 and the price of oil increased to $10.75 per barrel on July 1, 1977.

In Merrill's operations at Rock Canyon, Colorado, the current price is approximately $1.62 per Mcf for gas committed prior to January 1, 1975. Gas committed after January 1, 1975, which is the majority of the Rock Canyon production, is priced at approximately $1.78 per Mcf. Both prices include BTU adjustments and the first price also includes a 30% small producer's bonus.

Reserves

The following table summarizes proved and probable crude oil, natural gas liquids, and natural gas reserves before deducting royalties. The reserves estimates are based on evaluations by independent consulting engineers and Merrill's engineering staff. Comparative reserves are as follows:

Company Share Gross Reserves	June 30, 1977	June 30, 1976
Pipeline Natural Gas — Billion Cubic Feet	431	290
Crude Oil and Natural Gas Liquids — Barrels	2,471,000	2,081,000

Merrill's Foundation Creek 5-2 well, Rock Canyon, Colorado.

Acreage Holdings

As of June 30, 1977, the Company and its wholly-owned subsidiaries held 804,730 gross and 394,249 net acres, respectively, as indicated in the accompanying table.

ACREAGE	June 30, 1977		June 30, 1976	
Location	Gross Acres	Net Acres	Gross Acres	Net Acres
Alberta	545,196	297,029	570,008	349,937
British Columbia	11,673	4,988	10,810	4,540
Saskatchewan	39,600	13,264	240	144
Arctic Islands	114,146	19,024	114,146	19,024
East Coast — Offshore	—	—	72,169	6,014
United States	94,115	59,944	112,167	58,907
	804,730	394,249	879,540	438,566

1977 DRILLING RESULTS — GROSS WELLS (NET WELLS)

	EXPLORATORY			DEVELOPMENT			TOTAL		
	GAS	OIL	DRY	GAS	OIL	DRY	GAS	OIL	DRY
Canada	6 (1.80)	2 (1.32)	6 (2.38)	31 (10.25)	3 (2.90)	9 (6.19)	37 (12.05)	5 (4.22)	15 (8.57)
U.S.	5 (4.25)	—	—	3 (3.00)	2 (.90)	—	8 (7.25)	2 (.90)	—
Total	11 (6.05)	2 (1.32)	6 (2.38)	34 (13.25)	5 (3.80)	9 (6.19)	45 (19.30)	7 (5.12)	15 (8.57)
Total Wells	EXPLORATORY 19 (9.75)			DEVELOPMENT 48 (23.24)			TOTAL 67 (32.99)		

Consolidated Statement of Operations

(in Canadian dollars)

	Year Ended June 30 1977	1976
Revenue:		
Oil and gas production revenue	$16,181,000	$10,382,000
Crown and overriding royalties paid	5,486,000	3,475,000
	10,695,000	6,907,000
Interest and other income	150,000	170,000
	10,845,000	7,077,000
Costs and Expenses:		
Production and operating	1,563,000	1,012,000
General and administrative	1,477,000	1,122,000
Interest on long-term debt	969,000	1,133,000
Interest on short-term debt	116,000	—
Interest on income debenture	260,000	260,000
Mining exploration	148,000	—
Loss on translation of foreign currency (Note 1)	192,000	—
	4,725,000	3,527,000
Funds generated from continuing operations before current income taxes	6,120,000	3,550,000
Depletion and depreciation	1,816,000	1,195,000
Income from continuing operations before income taxes	4,304,000	2,355,000
Income Taxes (Note 6):		
Current (Provincial royalty tax credit)	(1,000,000)	(709,000)
Deferred	2,372,000	1,371,000
	1,372,000	662,000
Income from continuing operations — oil and gas	2,932,000	1,693,000
Loss from discontinued operations (Note 2)	—	(296,000)
Income before extraordinary items (Note 1)	2,932,000	1,397,000
Reduction of income taxes	623,000	428,000
Gain on sale of investments	—	11,000
Gain on disposal of non-current assets related to discontinued operations (Note 2)	—	151,000
Net Income For The Year	$ 3,555,000	$ 1,987,000
Income per common share (Note 11):		
Before extraordinary items	$ 1.415	$ 0.694
Extraordinary items	0.301	0.293
Net Income For The Year	$ 1.716	$ 0.987

See accompanying notes.

Consolidated Statement of Changes in Financial Position

(in Canadian dollars)

	Year Ended June 30 1977	1976
Working capital was provided by:		
Operations —		
Funds generated from (used in) operations before current income taxes:		
Continuing — oil and gas	$ 6,120,000	$ 3,550,000
Discontinued	—	(190,000)
	6,120,000	3,360,000
Current income taxes — discontinued operations	—	(104,000)
Provincial royalty tax credit	1,000,000	709,000
	7,120,000	3,965,000
Net proceeds on disposal of non-current assets related to discontinued operations	—	6,872,000
Proceeds on disposal of investments	12,000	173,000
New long-term debt	4,389,000	1,531,000
Issue of share capital	301,000	—
Collection of notes and mortgages receivable	306,000	—
Sale of properties and equipment	—	91,000
Decrease in advances to drilling fund programs	18,000	178,000
Gas pipeline advances	—	329,000
	12,146,000	13,139,000
Working capital was used for:		
Additions to properties and equipment — continuing operations	11,246,000	6,277,000
Additions to properties and equipment — discontinued operations	—	170,000
Reduction of long-term debt	2,004,000	5,451,000
Notes and mortgages receivable	449,000	941,000
Special taxes paid on surplus of subsidiaries	—	149,000
Acquisition of shares of affiliates and subsidiaries	—	20,000
Other	—	49,000
	13,699,000	13,057,000
Increase (Decrease) In Working Capital For The Year (Note 3)	$ (1,553,000)	$ 82,000

See accompanying notes.

Consolidated Statement of Financial Position

(in Canadian dollars)

	June 30 1977	June 30 1976
Current assets:		
Accounts receivable	$ 2,915,000	$ 2,232,000
Provincial royalty tax credit receivable	1,302,000	724,000
Equipment inventory	577,000	—
Prepaid expenses and deposits	115,000	33,000
Note and mortgage payments due within one year	386,000	433,000
	5,295,000	3,422,000
Current liabilities:		
Bank demand loans and indebtedness (Note 4)	1,114,000	275,000
Accounts payable and accrued liabilities	4,332,000	2,143,000
Current portion of long-term debt	2,309,000	1,911,000
	7,755,000	4,329,000
Working capital deficiency	2,460,000	907,000
Properties and equipment:		
Petroleum and natural gas leases, rights, exploration and development costs thereon, less accumulated depletion of $3,049,000 (1976 — $1,910,000)	22,817,000	16,484,000
Equipment, less accumulated depreciation of $1,237,000 (1976 — $763,000)	9,595,000	7,092,000
Other, less accumulated depreciation of $198,000 (1976 — $147,000)	856,000	169,000
	33,268,000	23,745,000
Other assets:		
Notes and mortgages receivable	1,085,000	941,000
Unamortized costs — discontinued mining and milling operations (Note 2)	476,000	572,000
Other	132,000	143,000
	1,693,000	1,656,000
Capital employed	$32,501,000	$24,494,000
Represented by:		
Long-term debt (Note 5)	$13,847,000	$11,445,000
Deferred income taxes (Note 6)	5,185,000	3,436,000
	19,032,000	14,881,000
Shareholders' equity:		
Capital stock (Note 7)	6,993,000	6,692,000
Retained earnings (Note 8)	6,476,000	2,921,000
	13,469,000	9,613,000
Capital employed	$32,501,000	$24,494,000

APPROVED BY THE BOARD

H. REKUNYK, Director

J. M. THOMSON, Q.C., Director

See accompanying notes.

Notes to Consolidated Financial Statements
June 30, 1977

1. Summary of significant accounting policies:

(Reference should be made to Note 2 which refers to operations discontinued during fiscal 1976.)

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada. They are also in conformity in all material respects with accounting principles generally accepted in the United States.

Principles of consolidation —
The consolidated financial statements include the accounts of Canadian Merrill Ltd. and its subsidiaries, all of which were wholly-owned as of June 30, 1977 and 1976.

Foreign currency translation —
For 1977, assets and liabilities carried in a foreign currency (U.S. dollars) have been translated to Canadian dollars in accordance with Financial Accounting Standards Board Statement No. 8, as follows:

Current assets and liabilities and non-current liabilities at exchange rates prevailing at the date of the balance sheet, non-current assets at the exchange rates prevailing when acquired and revenues, costs and expenses at the monthly average rate of exchange. Translation adjustments are included in the determination of net income.

No material adjustment would have been required in the 1976 financial statements had this practice been followed for that year.

Inventories —
Equipment inventories, consisting primarily of tubular goods for gas field development, are valued at the lower of average cost or net realizable value.

Oil and gas drilling fund programs —
Pursuant to the authority granted to it as manager of certain oil and gas drilling programs, a subsidiary company, Provident Resources Ltd. ("Provident"), finances continuing programs' activities by term production bank loans, secured by assignments of title to certain program properties.

Advances to the drilling programs, amounting to

$204,000 (1976 — $221,000), have been allocated against equal amounts of term production bank loans.

Properties and equipment — depletion, depreciation and amortization

Oil and gas properties and equipment —
The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs relating to the exploration for and development of oil and gas reserves are capitalized. Such costs include acquisition costs, geological costs, exploration overhead, carrying charges of non-producing properties and costs of drilling both productive and non-productive wells. Production equipment and gas facilities are recorded at cost. Depletion and depreciation are provided using the unit of production method based on estimated proven reserves of oil and gas for the respective Canadian and foreign cost centres. No gains or losses are recognized upon the sale or disposition of properties except under circumstances which result in major disposals of reserves.

Discontinued mining and milling operations —
Mining-mill buildings and equipment are carried at their unamortized cost which is estimated to be not greater than net realizable value. Production from the related copper ore body ceased in June 1975. The remaining cost of these assets is being amortized over the term of the lease with respect to the land upon which they are situated.

With the exception of costs related to the Perch River, Quebec mining claims, all exploration costs have been written off. While work to date has not established a proven ore reserve, the Company intends to continue to hold the Perch River claims.

The remaining period of amortization (approximately five years at June 30, 1977) for both mining-mill buildings and equipment and the Perch River exploration costs represents the anticipated maximum holding period during which sale and/or exploration possibilities will be considered.

Deferred income taxes —
Drilling exploration and lease acquisition costs and depreciation in excess of the related amounts provided in the accounts have been claimed for income tax purposes. The result of this practice has been to defer payment of income taxes otherwise payable to those future periods when the amount claimed for income tax purposes will be less than the amounts charged in the accounts.

Extraordinary items —
The Company follows Canadian accounting practice with respect to the definition of extraordinary items. The extraordinary items shown in the consolidated statement of operations (except for the income tax reduction) would be considered ordinary items under United States practice; income per common share before extraordinary items would be increased accordingly but net income would remain unchanged.

2. Discontinued operations:

During fiscal 1976, the Company disposed of its well servicing and equipment rentals and sales divisions. The rentals and sales division assets were sold to a director. Certain of the well servicing division assets were sold to former employees. Copper milling operations ceased in early fiscal 1976 and mining exploration operations were suspended. Results of operations of these divisions are included in the account, "Loss from discontinued operations" and comprise the following:

	1976
Well servicing and equipment rentals and sales:	
Revenue	$ 2,622,000
Loss before income taxes	$ (49,000)
Income taxes	(6,000)
Loss for the period	$ (55,000)
Milling-mining:	
Milling revenue (adjustments)	$ (37,000)
Loss before income taxes	$ (349,000)
Reduction of income taxes	108,000
Loss for the period	$ (241,000)
Combined loss for the period	$ (296,000)

The account, "Gain on disposal of non-current assets

related to discontinued operations" comprises:

Gain on sale of properties and equipment of the well servicing and equipment rentals and sales divisions	$ 2,017,000
Loss on sale of shares of a subsidiary engaged in the well servicing business	60,000
Other, net, primarily employee termination costs	210,000
	1,747,000
Deferred income taxes	625,000
	1,122,000
Write off of unamortized balance of excess of cost over underlying equity at the date of acquisition	971,000
	$ 151,000

The account, "Unamortized costs — discontinued mining and milling operations" comprises:

	1977	1976
Mining-mill buildings and equipment, at cost	$ 1,408,000	$1,418,000
Accumulated depreciation and amortization	1,188,000	1,153,000
	220,000	265,000
Deferred costs related to mining claims, net of accumulated amortization of $101,000 (1976 — $51,000)	256,000	307,000
	$ 476,000	$ 572,000

3. Changes in components of working capital:

	1977	1976
Increase (decrease) in current assets —		
Accounts receivable	$ 683,000	$ (768,000)
Provincial royalty tax credit receivable	578,000	472,000
Equipment inventory	577,000	—
Inventory — new and used oilfield equipment for resale	—	(359,000)
Other	82,000	(82,000)
Note and mortgage payments due within one year	(47,000)	433,000
	1,873,000	(304,000)
Less:		
Increase (decrease) in current liabilities —		
Bank demand loans and indebtedness	839,000	(336,000)
Accounts payable and accrued liabilities	2,189,000	181,000
Current portion of long-term debt	398,000	(231,000)
	3,426,000	(386,000)
Increase (decrease) in working capital for the year	$(1,553,000)	$ 82,000

4. Bank loans and indebtedness:

Bank loans and indebtedness are secured by a general assignment of accounts receivable, a floating charge debenture covering the assets of Provident and an assignment of interests (as well as the interests of the drilling fund programs) in petroleum and natural gas properties, together with specific assignments therefrom; interest on demand loans is presently $^1/_2$ of 1% over the Canadian prime rate ($8^1/_4$% at June 30, 1977).

5. Long-term debt:

	1977	1976
Secured convertible $6^1/_2$% income debenture, payable to 49% shareholder, due October 31, 1989, repayable in annual instalments of $400,000 commencing on October 31, 1980; convertible into common shares at $6 per share to February 28, 1979 and $7 per share thereafter to February 28, 1984; secured by a floating charge on all of the property and assets of the Company subject to specific permitted encumbrances and a pledge of the shares of Provident; includes restrictions as to acquisition and disposition of assets, indebtedness, amalgamation, authorization and issuance of share capital	$ 4,000,000	$ 4,000,000
Term production bank loans, interest at $^3/_4$ of 1% over the Canadian prime rate, evidenced by demand notes, secured as outlined in Note 4, repayable $152,000 Canadian monthly to 1981	7,133,000	7,940,000
Term production bank loans, interest at Royal Bank Base Rate for U.S. loans in Canada (7% at June 30, 1977) evidenced by demand notes; secured as outlined in Note 4, repayable $152,000 U.S. monthly commencing in 1982 to 1983. ($3,200,000 U.S. Funds; 1976 — $1,000,000 U.S. Funds)	3,388,000	1,000,000

	1977	1976
Term production bank loan, interest at 1½% over The First National Bank of Denver, ("FNB of D") prime rate, (7% at June 30, 1977), secured by a Mortgage, Security Agreement, and Assignment of Production on all producing properties located in the United States, evidenced by a demand note, repayable $21,000 U.S. monthly to 1981 ($958,000 U.S. Funds)	1,016,000	—
Mortgage bank loan, interest at 1% over the FNB of D prime rate, secured by a mortgage on an aircraft, evidenced by a demand note, repayable $30,000 U.S. quarterly to 1979 ($255,000 U.S. Funds)	270,000	—
Gas pipeline advances, interest free, due monthly to 1981 ($329,000 U.S. Funds; 1976 — $416,000 U.S. Funds)	349,000	416,000
	16,156,000	13,356,000
Less: Current portion of long term debt	2,309,000	1,911,000
	$13,847,000	$11,445,000

Principal repayments required in the respective currencies over the next five years are as follows:

	U.S. Funds	Canadian Funds
1978	$ 457,000	$1,824,000
1979	457,000	1,824,000
1980	352,000	1,824,000
1981	439,000	2,062,000
1982	1,824,000	400,000

6. Income taxes:

The Company and each of its subsidiaries are required to file separate tax returns. Prior to fiscal 1975, provisions for current and deferred income taxes, recorded in the consolidated financial statements, related solely to the subsidiary companies. No provision for income taxes was required in the accounts of Canadian Merrill Ltd. (as a corporation) since its operations to June 30, 1974, resulted in accounting losses. On a cumulative basis to June 30, 1974, its costs and expenses charged to operations exceeded the corresponding amounts deducted for tax purposes by approximately $3,900,000. Since the realization of the related possible future tax benefits was not virtually assured, they were not recorded in the accounts. Fiscal 1975, 1976 and 1977 operations of Canadian Merrill Ltd. (as a corporation) resulted in accounting income. The fiscal 1976 and 1977 consolidated provision for deferred income taxes includes the taxes which would have been payable on this accounting income had these taxes not been reduced (eliminated) by deducting, for tax purposes, previously unclaimed costs in excess of the related amounts charged to operations in fiscal 1976 and 1977. These reductions in taxes otherwise payable have been shown as an extraordinary item. As a result of the foregoing, the excess of approximately $3,900,000 has been reduced to nil at June 30, 1977 ($1,650,000 at June 30, 1976) and the related unrecorded possible future tax benefits have been reduced to nil.

In both fiscal 1977 and the fiscal 1976, the provisions for income taxes differ from the amounts obtained by applying the Canadian corporate income tax rate (approximately 47.0% in fiscal 1977 and approximately 47.5% in fiscal 1976) to the net income for the years plus the provisions for income taxes, before extraordinary items. The reasons for these net differences are as follows:

	1977		1976	
	$	% of Pre-Tax Income	$	% of Pre-Tax Income
Continuing operations:				
Net income for the year	$2,932,000		$1,693,000	
Add: Income tax provision	1,372,000		662,000	
Pre-tax income	$4,304,000	100.0%	$2,355,000	100.0%
Computed "expected" tax expense	$2,023,000	47.0%		
Increase (reductions) in taxes resulting from:				
(a) Non-deductible items:				
Crown royalties	$2,102,000		$1,302,000	
Income debenture interest	122,000		123,000	
Loss on translation of foreign currency	90,000		—	
Other	6,000		3,000	
	2,320,000	53.9%	1,428,000	60.6%

	1977 $	1977 % of Pre-Tax Income	1976 $	1976 % of Pre-Tax Income
(b) Rate adjustments:				
Tax depletion allowance, historical rate — Canadian Merrill Ltd., as a corporation . .	—		(153,000)	
Production profit abatement . . .	—		(177,000)	
Resource allowance . . .	(1,255,000)		(495,000)	
Earned depletion .	(521,000)		(165,000)	
	(1,776,000)	(41.3%)	(990,000)	(42.0%)
(c) Provincial royalty tax credits and rebates recoverable . . .	(1,195,000)	(27.8%)	(895,000)	(38.0%)
Actual tax provision	$1,372,000	31.8%	$ 662,000	28.1%

7. Capital stock:

The Company has authorized capital stock of 2,000,000 preferred shares of $5 par value and 10,000,000 common shares of no par value. As at June 30, 1977, there were 2,073,870 (1976 — 2,013,920) common shares issued and fully paid.

Of the authorized but unissued common shares, the following are reserved for:

Secured convertible income debenture (Note 5) . .	666,667
Employees and officers — under the Incentive Stock Option Plan, options to purchase 13,300 shares (at prices from $5.00 to $5.85) are currently exercisable cumulatively in five equal annual instalments expiring in May, 1979	64,550
	731,217

During fiscal 1977, employee options covering 58,190 and 1,760 shares were exercised at prices of $5.00 and $5.85 per share respectively for an aggregate cash consideration of $301,246.

Subsequent to June 30, 1977, employee options covering 6,200 and 4,400 shares were exercised at prices of $5.00 and $5.85 per share respectively for an aggregate cash consideration of $56,740.

8. Consolidated retained earnings:

	1977	1976
Balance, beginning of the year	$2,921,000	$1,083,000
Net income for the year	3,555,000	1,987,000
Special taxes paid on surplus of subsidiaries	—	(149,000)
	$6,476,000	$2,921,000

9. Contingent liabilities and commitments:

The companies have commitments in the normal course of business, including Provident's agreements to manage the drilling fund programs.

To the extent that bank loans referred to in Note 1 are not repaid from the proceeds of production from, or sale of, program properties, Provident would be directly liable.

10. Remuneration of officers and directors:

The Company has eight directors who received fees of $14,885 as directors (1976 — $14,600) and eight officers, two of whom were also directors, who received remuneration of $205,155 (1976 — $243,476 to eight officers, five of whom were also directors) in their capacity as officers.

11. Income per common share:

Basic income per common share is based on the weighted average number of common shares outstanding during each fiscal year.

Fully diluted income per common share is based on the assumption that the 666,667 shares (1976 — 666,667) reserved for future issuance under the terms of the secured convertible income debenture and the 13,300 shares (1976 — 74,150) with respect to which options are granted under the Incentive Stock Option Plan had been issued at the beginning of each fiscal year. Income has been increased by the interest on the income debenture and earnings at 5% have been imputed based on the assumed after-tax interest which could have been earned on the funds received from the exercise of the options.

	Basic income (loss) per common share	Fully diluted income (loss) per common share
Fiscal 1977:		
Income before extraordinary items .	$1.415	$1.160
Extraordinary items	0.301	0.227
Net income for the year	$1.716	$1.387
Fiscal 1976:		
Income from continuing operations — oil and gas	$0.841	$0.716
Loss from discontinued operations .	(0.147)	(0.107)
Income before extraordinary items .	0.694	0.609
Extraordinary items	0.293	0.214
Net income for the year	$0.987	$0.823

Under United States accounting practice, basic and fully diluted income per share would not differ materially, except that extraordinary items (except for the income tax reduction) would not be considered extraordinary items.

12. Anti-inflation legislation:

The Company's sale of domestic production is not subject to the provisions of the Anti-inflation Act as the sale of such products is already governed by the Petroleum Administration Act. However, the Anti-inflation Act does impose certain restrictions with respect to employee and director compensation and dividends. In the opinion of management, the Company has in all material respects, complied with the guidelines since their announcement.

13. Subsequent event:

At a meeting of the Board of Directors of the Company held on September 23, 1977, a resolution was passed giving notice of the Company's intention to redeem, on November 1, 1977, the Secured Income Debenture described in Note 5. The debenture holder has the right to convert the Secured Income Debenture into 666,667 common shares of the Company prior to the redemption date.

14. Quarterly financial data (unaudited):

Summarized quarterly financial data for fiscal 1977 is as follows:

	Three Months Ended			
	Sept. 30/76	Dec. 31/76	March 31/77	June 30/77
	(Thousands except for per share amounts)			
Total revenue	$3,665	$4,189	$3,689	$4,788
Funds generated from operations before current income taxes	1,605	1,703	1,165	1,647
Income before extraordinary items	786	906	512	728
Net income	948	1,093	680	834
Net income per share . . .	$ 0.46	$ 0.52	$ 0.33	$ 0.41

During the first and second quarters the Company failed to record, in error, the tax benefits arising from earned depletion in the Canadian tax calculation. Accordingly, the financial data set out in the above table has been restated to reflect the required adjustment. The interim financial information set out in this note has not been subjected to a limited review by the Company's external auditors.

Auditors' Report

DELOITTE, HASKINS & SELLS
Chartered Accountants
700-202 SIXTH AVENUE S.W., CALGARY, ALBERTA T2P 2R9

To the Shareholders of
Canadian Merrill Ltd.:

We have examined the consolidated statement of financial position of Canadian Merrill Ltd. as at June 30, 1977 and the consolidated statements of operations and changes in financial position for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances. The consolidated financial statements of Canadian Merrill Ltd. for the year ended June 30, 1976 were examined by other chartered accountants whose report dated September 15, 1976 expressed an unqualified opinion on those statements.

In our opinion, these consolidated financial statements are properly drawn up so as to exhibit a true and correct view of the state of the affairs of the company as at June 30, 1977 and the results of its operations and the changes in its financial position for the year then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Deloitte, Haskins & Sells

September 23, 1977

Auditors

Management's Discussion and Analysis of The Summary of Operations

FISCAL 1977 COMPARED TO FISCAL 1976

Revenue, pre-tax cash flow and net income, increased significantly due to: (a) higher production of natural gas and crude oil, up 24.3% and 7.1%, respectively; and (b) higher average wellhead prices for natural gas and crude oil, up 33.8% to $1.16 per Mcf and 5.2% to $9.09 per barrel, respectively.

Higher gas production resulted primarily from new gas fields being placed on production in the spring of 1977 combined with a full year's effect of other new gas production which commenced in early 1976. This result was achieved despite gas sales curtailments in 1977 as a consequence of a market over-supply situation.

General and administrative expenses increased by 31.6% due to the higher payroll and benefit costs associated with an increase in the Company's management and professional staff and the higher occupancy costs of the Company's new and expanded offices.

The loss of $192,000 on the translation of U.S. currency into Canadian results from the application of FASB Statement No. 8, whereby all U.S. dollar long-term debt is converted at the year-end exchange rate into the Canadian equivalent as though the purchase of U.S. funds with Canadian funds would be necessary to retire the debt at that time. To the extent that income from Merrill's U.S. oil and gas production is generated to repay the U.S. dollar debt or that the exchange rate between the respective currencies varies from time to time, continuing gains or losses will be recorded.

Interest charges were, in aggregate, approximately equal to those incurred in 1976 despite a higher average debt outstanding due to the lower effective interest rates applicable throughout all of fiscal 1977.

FISCAL 1976 COMPARED TO FISCAL 1975

Revenue and net income from oil and gas operations increased significantly as the result of: (a) higher production of natural gas (up 34.6%) due to the effect of a full year of production from the properties purchased from former participants of Provident sponsored drilling fund programs effective January 1, 1975 and further new reserves put into production in early 1976; (b) higher average wellhead prices for natural gas, 86.7¢ for fiscal 1976 versus 41.7¢ for fiscal 1975; and (c) higher crude oil production and average wellhead prices received. Crown and overriding royalties also increased as a percentage of total oil and gas production revenue to 33.5% from 27% for the previous year reflecting the higher provincial Crown royalty scale applicable to higher natural gas prices. Interest costs are double the fiscal 1975 experience reflecting higher average levels of indebtedness throughout 1976 as compared to 1975 as a result of the purchase of producing properties in early 1975, and higher rates of interest.

FISCAL 1975 COMPARED TO FISCAL 1974

Revenue from oil and gas operations increased significantly as the result of: (a) higher production of natural gas (up 29%), primarily from the purchase of producing properties from former participants of Provident sponsored drilling fund programs effective January 1, 1975 and new reserves put on production in January, 1975; (b) higher average wellhead prices for natural gas; and (c) higher average wellhead prices for crude oil despite a decline in actual production. However, offsetting these revenue gains were more significant increases in Government royalties, averaging over 27% of gross revenues for 1975 versus approximately 19% for 1974. Interest costs on bank borrowings were higher as the result of the purchase of proven reserves in early 1975. Interest costs applicable to the $6^1/_2$% income debenture, which are not deductible for income tax purposes, are included in the fiscal 1975 results for a full year versus a four month period applicable to fiscal 1974.

STOCK PRICE

The following table indicates the quarterly high bid and low bid prices for the common stock of the Company on the Toronto Stock Exchange for the last two fiscal years of the Company.

	Fiscal 1977		Fiscal 1976	
First Quarter	$10.75	$ 8.75	$ 6.00	$4.40
Second Quarter	13.75	9.12	6.00	4.65
Third Quarter	15.00	12.50	6.75	5.25
Fourth Quarter	15.37	12.87	10.62	6.00

Five Year Financial Review

(Thousands of dollars, except per share amounts)

	Year Ended June 30				
	1977	1976	1975	1974	1973
Revenue:					
Oil and gas production revenue	$16,181	$10,382	$4,553	$2,486	$1,474
Crown and overriding royalties paid	5,486	3,475	1,240	480	191
	10,695	6,907	3,313	2,006	1,283
Interest and other income	150	170	103	115	18
	10,845	7,077	3,416	2,121	1,301
Costs and Expenses:					
Production and operating	1,563	1,012	673	456	324
General and administrative	1,477	1,122	788	616	301
Interest — long-term	969	1,133	552	464	266
— short-term	116	—	—	—	—
Interest on income debenture	260	260	260	87	—
Mining exploration	148	—	—	—	—
Loss on translation of foreign currency	192	—	—	—	—
	4,725	3,527	2,273	1,623	891
Funds Generated from Continuing Operations, before income taxes	6,120	3,550	1,143	498	410
Per common share	$ 2.95	$ 1.76	$ 0.57	$ 0.25	$ 0.20
Depletion and depreciation	1,816	1,195	782	426	293
Income before income taxes	4,304	2,355	361	72	117
Income Taxes					
Current (Provincial Royalty tax credit)	(1,000)	(709)	(256)	—	—
Deferred	2,372	1,371	417	74	99
	1,372	662	161	74	99
Income from Continuing Operations	2,932	1,693	200	(2)	18
(Loss) Income from Discontinued Operations	—	(296)	237	652	453
Income before Extraordinary Items	2,932	1,397	437	650	471
Per common share	$ 1.42	$ 0.69	$ 0.22	$ 0.32	$ 0.24
Provision for decline in value of marketable securities	—	—	(300)	(300)	—
Gain (loss) on sale of shares	—	11	—	38	(28)
Gain on sale of drilling rig	—	—	—	—	59
Reduction of income taxes	623	428	358	—	—
Gain on disposal of non-current assets related to discontinued operations	—	151	—	—	—
Net Income for the Year	$ 3,555	$ 1,987	$ 495	$ 388	$ 502
Per Common Share	$ 1.72	$ 0.99	$ 0.25	$ 0.19	$ 0.25

Canadian Merrill Ltd.

Executive Office
Suite 2900, Scotia Centre
700 - 2nd Street S.W.
Calgary, Alberta T2P 2W2

Head Office
1203 IBM Building
5 Place Ville Marie
Montreal, Quebec H3B 2H1

Stock Exchange Listings
TORONTO STOCK EXCHANGE
Toronto, Ontario
MONTREAL STOCK EXCHANGE
Montreal, Quebec
AMERICAN STOCK EXCHANGE
New York, New York

Auditors
DELOITTE, HASKINS & SELLS
Chartered Accountants,
Calgary, Alberta

Principal Operating Subsidiaries
PROVIDENT RESOURCES LTD.
PROVIDENT RESOURCES, INC.

Transfer Agents & Registrar
CANADA PERMANENT TRUST COMPANY,
Montreal, Quebec
Toronto, Ontario
Calgary, Alberta
THE CANADIAN BANK OF COMMERCE
TRUST COMPANY
New York, New York

Bankers
THE ROYAL BANK OF CANADA
Calgary, Alberta
THE FIRST NATIONAL BANK OF DENVER
Denver, Colorado

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Canadian Merrill Ltd.

Annual Report December 31, 1977

Canadian Merrill Ltd.

Incorporated Under the Laws of the Province of Quebec

DIRECTORS

ROBIN J. ABERCROMBIE,
Calgary, Alberta
Senior Vice-President of the Alberta Gas Trunk Line Company Limited

ROBERT S. BLACKETT
Calgary, Alberta
Executive Vice-President of the Company

JOHN L. CARPENTER
Toronto, Ontario
Executive Vice-President of Hudson Bay Mining and Smelting Co., Limited

ADRIAN M. DOULL,
Toronto, Ontario
Senior Vice-President, Finance of Hudson Bay Mining and Smelting Co., Limited

E. PETER GUSH,
Toronto, Ontario
President, Hudson Bay Mining and Smelting Co., Limited

HORACE REKUNYK,
Calgary, Alberta
Chairman of the Board and President of the Company

C. KEITH TAYLOR, Q.C.
Toronto, Ontario
Senior Vice-President, Administration, Secretary and General Counsel of Hudson Bay Mining and Smelting Co., Limited

JAMES M. THOMSON, Q.C.,
Calgary, Alberta
Associate in Milner & Steer

OFFICERS

HORACE REKUNYK,
Chairman of the Board and President

ROBERT S. BLACKETT
Executive Vice-President

CHARLES W. TEMPLETON
Senior Vice-President, Exploration

ROBERT F. GILMOUR
Vice-President, Production and Engineering

G. BARRY PADLEY, C.A.
Vice-President, Finance and Treasurer

WILLIAM C. MILLS
Secretary

JAMES N. WILLIAMS, C.A.
Assistant Treasurer

LUCILLE BRIMACOMBE
Comptroller

Comparative Highlights

	Six Months December 31 1977	Six Months December 31 1976	Increase Per Cent	Twelve Months June 30 1977
Financial				
Revenue by source:				
Oil and gas production	$10,432,000	$ 7,761,000	34.4	$16,181,000
Interest and other income	58,000	93,000	(37.6)	150,000
Gross revenue	10,490,000	7,854,000	33.5	16,331,000
Cash flow from operations	3,807,000	3,307,000	15.1	6,120,000
Per share	1.58	1.60		2.95
Earnings before extraordinary items	1,685,000	1,671,000	—	2,932,000
Per share	.70	.81		1.42
Net earnings for the period	1,685,000	2,020,000	(16.6)	3,555,000
Per share	.70	.98		1.72
Capital expenditures	6,551,000	6,862,000	(4.5)	11,246,000
Working capital balance (deficit)	1,640,000	(3,090,000)	—	(2,460,000)
Total capital employed	41,840,000	27,973,000	49.5	32,501,000
Shares outstanding — average	2,416,018	2,070,578	16.7	2,072,224
Operating				
Natural gas production, net before royalties:				
Total — million cubic feet	6,496	5,891	10.3	11,821
Daily average — million cubic feet	35.3	32.0		32.4
Oil production, net before royalties:				
Total — barrels	124,454	127,126	(2.1)	240,875
Daily average — barrels	676	691		660
Number of net productive wells:				
Gas	130.9	108.5	20.6	120.3
Oil	64.9	64.7	—	64.9
Acreage holdings:				
Gross	655,721	827,670	(20.8)	804,730
Net	363,480	379,055	(4.1)	394,249

Report to the Shareholders

This is the Company's first December 31 year-end Annual Report following approval by the shareholders in October, 1977 to change the year-end from June 30. As the Company published an Annual Report for the fiscal year ended June 30, 1977, the comparative figures in this report are for the six-month periods ended December 31, 1977 and 1976, respectively.

Financial Review

Gross revenue from oil and gas operations for the six months ended December 31, 1977 increased 34% to $10,432,000 from $7,761,000 in the same period in 1976. Pre-tax cash flow increased to $3,807,000 from $3,307,000 in 1976. Earnings before extraordinary items in 1977 were $1,685,000 or 70¢ per share compared with $1,671,000 or 81¢ per share (66¢ per share, fully diluted). Net earnings after extraordinary items to December 31, 1977 were $1,685,000 or 70¢ per share compared with $2,020,000 or 98¢ per share (78¢ per share, fully diluted) last year.

The Company's $4,000,000 Secured Convertible Income Debenture was converted during the period into 666,667 common shares. The fully diluted earnings per share noted above for the six months ended December 31, 1976 assume the conversion of the income debenture and exercise of all outstanding employee stock options as at July 1, 1976.

Net earnings, before extraordinary items, in the respective fiscal periods were virtually unchanged despite the substantial improvement in gross revenues in the 1977 period. This is the result of increased production, operating and administrative costs, higher depletion charges and an increase in the effective tax rate in 1977.

The increased operating costs reflect major well servicing and maintenance programs on certain of the Company's producing properties in order to maintain or increase productivity. The higher administrative costs are related to a significant expansion in the Company's management and technical staff. The benefits from these increased costs will accrue to future operating periods.

The Company has renegotiated its Canadian long-term bank production loans so that no principal repayment is due until 1982. This debt repayment moratorium will allow the Company to optimize its re-investment programs in oil and gas exploration, development and acquisitions during the next several years when it is felt that opportunities will be abundant.

The Company's working capital balance at December 31, 1977 was $1,640,000 compared with a deficit of $2,460,000 at June 30, 1977, an improvement of $4,100,000.

The statements for the twelve-month period from July 1, 1976 to June 30, 1977, which include the December

31, 1976 period, were audited. The December 31, 1976 comparative figures in the consolidated financial statements are unaudited because the cut-off used for the December 31, 1976 figures has not been specifically audited.

Exploration Review

The Company drilled or participated in five gross (3.12 net) exploratory wells in the six months ended December 31, 1977. All of these wells were completed as indicated gas producers, one each in the Stanmore and Edgerton fields in Alberta and three in the Rock Canyon area, Colorado.

The Company's acreage holdings were reduced during this period, principally as the result of surrendering all of the acreage held in the Arctic Islands. Other reductions in Alberta acreage were partially offset by acquisitions in new potential areas in the province and in western Saskatchewan and northeastern British Columbia.

Further exploratory work on the Antoinette Lake claims located near Chibougamau, Quebec did not establish a commercial ore body on this zinc, silver and gold prospect. No further work is planned on these claims in the immediate future.

Production Review

The Company drilled 16 gross (9.36 net) development wells in the last six months of 1977. This drilling resulted in 7.43 net gas wells and 1.93 net abandonments. The overall success ratio was 81%.

Natural gas production before royalties increased 10% to 6.5 billion cubic feet, an average of 35.3 million cubic feet per day. Crude oil production totalled 124,454 barrels or 676 barrels per day which was a slight reduction from 1976.

Corporate Review

Hudson Bay Mining and Smelting Co., Limited increased its common share equity interest in the Company to 62% through the conversion of the $4,000,000 $6\frac{1}{2}$% Secured Convertible Income Debenture and the purchase of additional shares on the open market. On the conversion of this debenture, 666,667 common shares of the Company were issued to Hudson Bay which now owns 1,704,002 Merrill common shares.

The adverse effect of the current oversupply condition in the Canadian natural gas market will likely be reduced through short-term gas export arrangements with the United States. Such arrangements would help to maintain Canadian drilling activity and would also reduce Canada's balance of payments deficit resulting from foreign oil imports.

Despite the current market conditions, it is anticipated that Merrill's gas sales will increase during 1978, particularly as the Rock Canyon wells come on stream. This production increase, combined with anticipated price increases, will result in improved revenues, cash flows and net earnings.

As a result, the Company will continue to expand its exploration activities in the three Western Canadian provinces and maintain its development drilling program in the Rock Canyon area, Colorado, and in selected Western Canadian prospects.

Your Directors wish to acknowledge with thanks the contribution made by Merrill's employees to the Company's growth and to its future prospects.

H. ReKunyk
Chairman of the Board

Calgary, Alberta
March 9, 1978

Operations

Exploration and Development

ALBERTA

The Company continued an active drilling program in the Stanmore area. One exploratory well and three development wells were completed as gas producers. Data from an oil discovery, reported in the first half of 1977, are currently being reviewed prior to undertaking a drilling program to develop this oil zone. Additional exploratory and development drilling will be undertaken in 1978 to evaluate undeveloped acreage.

The Company also acquired, with partners, options on 17,120 acres in the Stanmore-Sunnynook-Youngstown area on which a seismic program has been completed. Drilling will commence on these lands early in 1978.

In the Edwand area, the Company participated in drilling four wells, three of which were completed as gas wells. Additional infill wells have been planned for 1978.

In other areas of Alberta, gas wells were completed at Birch (30.2%), Edgerton (15% ORR) and two wells at Medicine Hat (8.75%).

Drilling plans have also been finalized for the Birch, Warwick, Peco, Leismer, Lyle Lake and Steen River areas in Alberta.

SASKATCHEWAN

The Company acquired a 33.3% interest in the Livelong area (38,400 acres) and the Peck Lake area (1,920 acres) on which seismic programs have been completed. A program of four exploratory wells will be drilled in 1978 to evaluate the Cretaceous sands.

BRITISH COLUMBIA

The Pacific Provident Fox d-60-D well, reported as an oil well in the 1977 Annual Report, encountered water production problems shortly after being placed on production and was suspended pending a review of all well data.

COLORADO

In the Rock Canyon area, the Company drilled three exploratory and four development gas wells. Five of these were 100% wells, with the remaining two being 62.5% and 50% interest wells. A program of seven wells has been scheduled for 1978.

Production Operations

Merrill and its subsidiary companies held interests in 231 gross gas wells (130.9 net gas wells) and 376 gross oil wells (64.9 net oil wells) at December 31, 1977. These producing properties are located primarily in the Province of Alberta and the States of Colorado, Montana and Wyoming.

The Company's gas production, before royalties, increased 10% to 6.5 billion cubic feet (35.3 million cubic feet per day) in the six months ended December 31, 1977 from 5.9 billion cubic feet (32.0 million cubic feet per day) in the same period in 1976. This increase was primarily due to the expansion of the Company's Stanmore gas plant and gathering system that was completed in early 1977. The level of gas production in the last six months was lower than anticipated following curtailments in the Company's Alberta gas production as a result of current market oversupply conditions and delays by the gas purchaser in completing production facilities to serve Merrill's gas wells in Colorado.

Merrill's oil production, before royalties, was slightly lower in the six months ended December 31, 1977 at

DRILLING RESULTS — SIX MONTHS TO DECEMBER 31, 1977
GROSS WELLS (NET WELLS)

	EXPLORATORY			DEVELOPMENT			TOTAL		
	GAS	OIL	DRY	GAS	OIL	DRY	GAS	OIL	DRY
Canada	2 (.12)	—	—	9 (4.30)	—	3 (1.93)	11 (4.42)	—	3 (1.93)
U.S.	3 (3.00)	—	—	4 (3.13)	—	—	7 (6.13)	—	—
Total	5 (3.12)	—	—	13 (7.43)	—	3 (1.93)	18 (10.55)	—	3 (1.93)
Total Wells	EXPLORATORY 5 (3.12)			DEVELOPMENT 16 (9.36)			TOTAL 21 (12.48)		

124,454 barrels (676 barrels per day) compared with 127,126 barrels (691 barrels per day) last year.

The average gas price received by Merrill for Canadian gas sales increased to $1.40 per thousand cubic feet (Mcf) from $1.16 per Mcf in the fiscal year ended June 30, 1977. The Company's average oil price was $10.69 per barrel in the last six months compared with $9.09 to June 30, 1977. The majority of Merrill's gas production from the Rock Canyon area, Colorado, is under contract for a base price of $1.48 per Mcf plus a BTU adjustment that can be as great as 30¢ per Mcf.

During 1978 new gas compression facilities will be placed on stream at Baxter-Wainwright and Edgerton which will increase gas sales from these fields.

An experimental production program in the Princess oil field late in 1977 resulted in a five-fold increase in oil production from this field. This program will be expanded in 1978 and continued success could result in additional development drilling.

Gas gathering systems will be extended to tie in additional gas reserves in the South Edwand and Sunnynook fields which are under contract but not currently on production.

Reserves

The Company's proved and probable crude oil, natural gas liquids and natural gas reserves, before deducting royalties, are summarized in the following table.

These reserve estimates are based on evaluations by Merrill's engineering staff.

RESERVES

Company Share Gross Reserves	Dec. 31 1977	June 30 1977	June 30 1976
Pipeline Natural Gas — Billion Cubic Feet	423	431	290
Crude Oil and Natural Gas Liquids — Barrels	2,450,000	2,471,000	2,081,000

Acreage Holdings

At December 31, 1977, the Company and its wholly-owned subsidiaries held interests in 655,721 gross acres of petroleum and natural gas rights equivalent to 363,480 net acres. This reflects a reduction in holdings since June 30, 1977 as a result of lease selections made out of large acreage blocks in Alberta and the surrender of the Company's holdings in the Arctic Islands.

ACREAGE

	December 31, 1977		June 30, 1977	
Location	Gross Acres	Net Acres	Gross Acres	Net Acres
Alberta	492,641	273,432	545,196	297,029
British Columbia	30,140	14,222	11,673	4,988
Saskatchewan	40,560	13,584	39,600	13,264
Arctic Islands	—	—	114,146	19,024
United States	92,380	62,242	94,115	59,944
	655,721	363,480	804,730	394,249

Consolidated Statement of Operations

(in Canadian dollars)

	Six Months Ended December 31, 1977	Six Months Ended December 31, 1976 (Unaudited)	Year Ended June 30, 1977
Revenue:			
Oil and gas production	$10,432,000	$7,761,000	$16,181,000
Crown and overriding royalties paid	3,742,000	2,597,000	5,486,000
	6,690,000	5,164,000	10,695,000
Interest and other income	58,000	93,000	150,000
	6,748,000	5,257,000	10,845,000
Costs and Expenses:			
Production and operating	1,118,000	604,000	1,563,000
General and administrative	923,000	649,000	1,477,000
Interest on long-term debt	545,000	487,000	969,000
Interest on short-term debt	94,000	23,000	116,000
Interest on income debenture	—	130,000	260,000
Mining exploration	83,000	57,000	148,000
Loss on translation of foreign currency	178,000	—	192,000
	2,941,000	1,950,000	4,725,000
Funds generated from operations before current income taxes	3,807,000	3,307,000	6,120,000
Depletion and depreciation	1,066,000	896,000	1,816,000
Earnings Before Income Taxes	2,741,000	2,411,000	4,304,000
Income Taxes (Note 6):			
Current (Provincial royalty tax credit)	(500,000)	(500,000)	(1,000,000)
Deferred	1,556,000	1,240,000	2,372,000
	1,056,000	740,000	1,372,000
Earnings before extraordinary item	1,685,000	1,671,000	2,932,000
Reduction of income taxes	—	349,000	623,000
Net Earnings For The Period	$ 1,685,000	$2,020,000	$ 3,555,000
Earnings per common share (Note 11):			
Before extraordinary item	$ 0.697	$ 0.807	$ 1.415
Extraordinary item	—	0.169	0.301
Net Earnings For The Period	$ 0.697	$ 0.976	$ 1.716

See accompanying notes

Consolidated Statement of Changes in Financial Position

(in Canadian dollars)

	Six Months Ended December 31, 1977	Six Months Ended December 31, 1976 (Unaudited)	Year Ended June 30, 1977
Working capital was provided by:			
Operations —			
Funds generated before current income taxes	$ 3,807,000	$ 3,307,000	$ 6,120,000
Provincial royalty tax credit	500,000	500,000	1,000,000
	4,307,000	3,807,000	7,120,000
Issue of share capital (Note 7)	4,057,000	301,000	301,000
New long-term debt	5,259,000	1,240,000	4,389,000
Reclassification of current portion of debt to long-term	1,824,000	—	—
Collection of notes and mortgages receivable	360,000	292,000	306,000
Decrease (increase) in advances to drilling fund programs	132,000	(18,000)	18,000
Sale of properties and equipment	60,000	—	—
Other	5,000	12,000	12,000
	16,004,000	5,634,000	12,146,000
Working capital was used for:			
Additions to properties and equipment	6,551,000	6,862,000	11,246,000
Reduction of long-term debt (Note 7)	5,156,000	955,000	2,004,000
Notes and mortgages receivable	60,000	—	449,000
Other	137,000	—	—
	11,904,000	7,817,000	13,699,000
Increase (Decrease) In Working Capital For The Period	$ 4,100,000	$(2,183,000)	$(1,553,000)
Changes in components of working capital:			
Increase (decrease) in current assets —			
Cash	519,000	40,000	—
Accounts receivable	797,000	205,000	683,000
Provincial royalty tax credit receivable	198,000	462,000	578,000
Equipment inventory	88,000	—	577,000
Other	(97,000)	167,000	82,000
Note and mortgage payments due within one year	(81,000)	—	(47,000)
	1,424,000	874,000	1,873,000
Less:			
Increase (decrease) in current liabilities —			
Bank demand loans and indebtedness	(1,114,000)	860,000	839,000
Accounts payable and accrued liabilities	154,000	2,117,000	2,189,000
Current portion of long-term debt	(1,716,000)	80,000	398,000
	(2,676,000)	3,057,000	3,426,000
Increase (Decrease) in Working Capital	$ 4,100,000	$(2,183,000)	$(1,553,000)

See accompanying notes

Consolidated Statement of Financial Position

(in Canadian dollars)

	December 31, 1977	June 30, 1977
Current assets:		
Cash	$ 519,000	$ —
Accounts receivable	3,712,000	2,915,000
Provincial royalty tax credit receivable	1,500,000	1,302,000
Equipment inventory	665,000	577,000
Prepaid expenses and deposits	18,000	115,000
Note and mortgage payments due within one year	305,000	386,000
	6,719,000	5,295,000
Current liabilities:		
Operating bank loans and indebtedness	—	1,114,000
Accounts payable and accrued liabilities	4,486,000	4,332,000
Current portion of long-term debt	593,000	2,309,000
	5,079,000	7,755,000
Working capital (deficiency)	1,640,000	(2,460,000)
Properties and equipment:		
Petroleum and natural gas leases, rights, exploration and development costs thereon, less accumulated depletion of $3,695,000 (June 30, 1977 — $3,049,000)	26,714,000	22,817,000
Equipment, less accumulated depreciation of $1,516,000 (June 30, 1977 — $1,217,000)	10,960,000	9,595,000
Other, less accumulated depreciation of $272,000 (June 30, 1977 — $198,000)	1,065,000	856,000
	38,739,000	33,268,000
Other assets:		
Notes and mortgages receivable	784,000	1,085,000
Unamortized costs — discontinued mining and milling operations (Note 3)	428,000	476,000
Other	249,000	132,000
	1,461,000	1,693,000
Capital employed	$41,840,000	$32,501,000
Represented by:		
Long-term debt (Note 5)	$15,906,000	$13,847,000
Deferred income taxes	6,723,000	5,185,000
	22,629,000	19,032,000
Shareholders' equity:		
Capital stock (Note 7)	11,050,000	6,993,000
Retained earnings (Note 8)	8,161,000	6,476,000
	19,211,000	13,469,000
Capital employed	$41,840,000	$32,501,000

APPROVED BY THE BOARD

H. REKUNYK, Director J. M. THOMSON, Q.C., Director

See accompanying notes

Notes to the Consolidated Financial Statements
December 31, 1977

1. Summary of significant accounting policies:

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in Canada. They are also in conformity in all material respects with accounting principles generally accepted in the United States.

Principles of consolidation —

The consolidated financial statements include the accounts of Canadian Merrill Ltd. and its subsidiaries, all of which were wholly-owned at December 31, 1977 and June 30, 1977.

Foreign currency translation —

Assets and liabilities carried in a foreign currency (U.S. dollars) have been translated to Canadian dollars in accordance with Financial Accounting Standards Board Statement No. 8, as follows:

Current assets and liabilities and non-current liabilities at exchange rates prevailing at the date of the balance sheet, non-current assets at the exchange rates prevailing when acquired and revenues, costs and expenses at the monthly average rate of exchange. Translation adjustments are included in the determination of net earnings.

Inventory —

Equipment inventory, consisting primarily of tubular goods for gas field development, is valued at the lower of average cost or net realizable value.

Oil and gas drilling fund programs —

Pursuant to the authority granted to it as manager of certain oil and gas drilling programs, a subsidiary company, Provident Resources Ltd. ("Provident"), finances continuing programs' activities by term production bank loans, secured by assignments of title to certain program properties.

Advances to the drilling programs, amounting to $72,000 (June 30, 1977 — $204,000), have been allocated against equal amounts of term production bank loans.

Properties and equipment — depletion, depreciation and amortization —

Oil and gas properties and equipment —

The Company follows the full cost method of accounting for petroleum and natural gas properties whereby all costs relating to the exploration for and development of oil and gas reserves are capitalized. Such costs include acquisition costs, geological costs, exploration overhead, carrying charges of non-producing properties and costs of drilling both productive and non-productive wells. Production equipment and gas facilities are recorded at cost. Depletion and depreciation are provided using the unit of production method based on estimated proven reserves of oil and gas for the respective Canadian and foreign cost centres. No gains or losses are recognized upon the sale or disposition of properties except under circumstances which result in major disposals of reserves.

In December, 1977, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 19 which will require oil and gas producing companies, using accounting principles generally accepted in the United States, to follow a form of successful efforts accounting. In general terms, unsuccessful exploration costs will be charged directly to earnings rather than being capitalized and amortized over future periods.

The Company is currently reviewing the impact of this new FASB requirement on its financial results because it reports to the Securities and Exchange Commission. The Company has not yet determined whether it will adopt this change in accounting method. Due to the complexity of the change, time has not permitted the Company to quantify the effect of this proposed change from the full cost to the successful efforts method on earnings or shareholders' investment. However, the Company does not anticipate that any restatement would affect its ability to comply with the covenants of debt or other agreements.

Discontinued mining and milling operations —

Mining-mill buildings and equipment are carried at their unamortized cost which is estimated to be not greater than net realizable value. Production from the related copper ore body ceased in June, 1975. The remaining cost of these assets is being amortized over the term of the lease with respect to the land upon which they are situated.

With the exception of costs related to the Perch River, Quebec mining claims, all exploration costs have been written off. While work to date has not established a proven ore reserve, the Company intends to continue to hold the Perch River claims.

The remaining period of amortization (approximately four years at December 31, 1977) for both mining-mill

buildings and equipment and the Perch River exploration costs represents the anticipated maximum holding period during which sale and/or exploration possibilities will be considered.

Deferred income taxes —

Drilling exploration and lease acquisition costs and depreciation in excess of the related amounts provided in the accounts have been claimed for income tax purposes. The result of this practice has been to defer payment of income taxes otherwise payable to those future periods when the amount claimed for income tax purposes will be less than the amounts charged in the accounts.

2. Change of year-end:

At a meeting on October 31, 1977, the shareholders ratified a change of year-end from June 30 to December 31, effective December 31, 1977. As a result, to provide the shareholders with appropriate comparisons, the consolidated statements of operations and changes in financial position include figures for both the year ended June 30, 1977 and the six months ended December 31, 1976 (unaudited).

3. Unamortized costs — discontinued mining and milling operations:

	December 31, 1977	June 30, 1977
Mining-mill buildings and equipment, at cost	$1,407,000	$1,408,000
Accumulated depreciation and amortization	1,209,000	1,188,000
	198,000	220,000
Deferred costs related to mining claims, net of accumulated amortization of $127,000 (June 30, 1977 — $101,000)	230,000	256,000
	$ 428,000	$ 476,000

4. Bank loans and indebtedness:

The Company has an approved operating line of credit in the amount of $3,500,000. Operating bank loans and indebtedness are secured by a general assignment of accounts receivable, a floating charge debenture covering the assets of Provident and an assignment of interests (as well as the interests of the drilling fund programs) in petroleum and natural gas properties, together with specific assignments of production therefrom; interest on demand loans is presently the Canadian prime rate (8¼% at December 31, 1977).

5. Long-term debt:

	December 31, 1977	June 30, 1977
Secured convertible 6½% income debenture, due October 31, 1989, repayable in annual instalments of $400,000 commencing on October 31, 1980; convertible into common shares at $6 per share to February 28, 1979 and $7 per share thereafter to February 28, 1984; converted in October, 1977 (Note 7)	$ —	$ 4,000,000
Term production bank loans, interest at ¾ of 1% over the Canadian prime rate evidenced by demand notes, secured as outlined in Note 4, repayable $116,000 Canadian monthly commencing in January, 1982 to 1987	8,342,000	7,133,000
Term production bank loans, interest at ¾ of 1% over Royal Bank Base Rate for U.S. loans in Canada (8¼% at December 31, 1977) evidenced by demand notes, secured as outlined in Note 4, repayable $80,000 U.S. monthly commencing in January, 1982 to 1987. ($5,750,000 U.S. Funds; June 30, 1977 — $3,200,000 U.S. Funds)	6,275,000	3,388,000
Term production bank loan, interest at 1½% over The First National Bank of Denver, ("FNB of D") prime rate (7¾% at December 31, 1977), secured by a Mortgage, Security Agreement, and Assignment of Production on all producing properties located in the United States, evidenced by a demand note, repayable $21,000 U.S. monthly to 1981 ($833,000 U.S. Funds; June 30, 1977 — $958,000 U.S. Funds)	912,000	1,016,000
Mortgage bank loan, interest at 1% over the FNB of D prime rate, secured by a mortgage on an aircraft, evidenced by a demand note, repayable $30,000 U.S. quarterly to 1979 ($195,000 U.S. Funds; June 30, 1977 — $255,000 U.S. Funds)	213,000	270,000
Gas pipeline advances, interest free due monthly to 1981 ($692,000 U.S. Funds; June 30, 1977 — $329,000 U.S. Funds)	757,000	349,000
	16,499,000	16,156,000
Less: Current portion of long-term debt	593,000	2,309,000
	$15,906,000	$13,847,000

Principal repayments required in the respective currencies over the next five years are as follows:

	U.S. Funds	Canadian Funds
1978	$542,000	Nil
1979	496,000	Nil
1980	422,000	Nil
1981	255,000	Nil
1982	963,000	$1,390,000

6. Income taxes:

The Company and each of its subsidiaries are required to file separate tax returns. Prior to fiscal 1975, provisions for current and deferred income taxes, recorded in the consolidated financial statements, related solely to the subsidiary companies. No provision for income taxes was required in the accounts of Canadian Merrill Ltd. (as a corporation) since its operations to June 30, 1974, resulted in accounting losses. On a cumulative basis to June 30, 1974, its costs and expenses charged to operations exceeded the corresponding amounts deducted for tax purposes by approximately $3,900,000. Since the realization of the related possible future tax benefits was not virtually assured, they were not recorded in the accounts. Fiscal 1975, 1976 and 1977 operations of Canadian Merrill Ltd. (as a corporation) resulted in accounting income. The June 30, 1977 consolidated provision for deferred income taxes includes the taxes which would have been payable on this accounting income had these taxes not been reduced (eliminated) by deducting, for tax purposes, previously unclaimed costs in excess of the related amounts charged to operations in 1977. As a result of the foregoing, the excess of approximately $3,900,000 was reduced to nil at June 30, 1977 and the related unrecorded possible future tax benefit was also reduced to nil.

In both the six-month period ended December 31, 1977 and the year ended June 30, 1977, the provisions for income taxes differ from the amounts obtained by applying the Canadian corporate income tax rate (approximately 47.0%) to the net earnings for the respective periods plus the provisions for income taxes, before extraordinary item. The reasons for these net differences are as follows:

	Six Months Ended December 31, 1977		Twelve Months Ended June 30, 1977	
	$	% of Pre-Tax Earnings	$	% of Pre-Tax Earnings
Net earnings for the period	$1,685,000		$2,932,000	
Add: Income tax provision	1,056,000		1,372,000	
Pre-tax earnings	$2,741,000	100.0%	$4,304,000	100.0%
Computed "expected" tax expense	$1,288,000	47.0%	$2,023,000	47.0%
Increase in taxes resulting from:				
(a) Non-deductible items:				
Crown royalties	1,433,000		2,102,000	
Income debenture interest	—		122,000	
Loss on translation of foreign currency	84,000		90,000	
Other	57,000		6,000	
	1,574,000	57.4%	2,320,000	53.9%
(b) Rate adjustments:				
Resource allowance	(832,000)		(1,255,000)	
Earned depletion	(333,000)		(521,000)	
	(1,165,000)	(42.5%)	(1,776,000)	(41.3%)
(c) Provincial royalty tax credits and rebates recoverable:	(641,000)	(23.4%)	(1,195,000)	(27.8%)
Actual tax provision	$1,056,000	38.5%	$1,372,000	31.8%

7. Capital stock:

The Company has authorized capital stock of 2,000,000 preferred shares of $5 par value and 10,000,000 common shares of no par value issuable for a maximum consideration of $11,100,000. As at December 31, 1977, there were 2,751,137 (June 30, 1977 — 2,073,870) common shares issued and fully paid.

Of the authorized but unissued common shares, 53,950 are reserved for issuance to employees and officers. Under the Incentive Stock Option Plan, options to purchase 2,470 shares at $5.00 per share are currently exercisable cumulatively in five equal annual instalments expiring in May 1979.

During the six-month period ended December 31, 1977, employee options covering 6,200 and 4,400 shares were exercised at prices of $5.00 and $5.85 per share respectively for an aggregate cash consideration of $56,740.

On October 31, 1977, 666,667 shares were issued by the Company for the cancellation of its $4,000,000 6½% Secured Convertible Income Debenture pursuant to the terms of the Debenture Agreement.

During the year ended June 30, 1977, employee options covering 58,190 and 1,760 shares were exercised at prices of $5.00 and $5.85 per share respectively for an aggregate cash consideration of $301,246.

8. Consolidated retained earnings:

	December 31, 1977	June 30, 1977
Balance, beginning of the period	$6,476,000	$2,921,000
Net earnings for the period	1,685,000	3,555,000
	$8,161,000	$6,476,000

9. Contingent liabilities and commitments:

The companies have commitments in the normal course of business, including Provident's agreements to manage the drilling fund programs.

To the extent that bank loans referred to in Note 1 are not repaid from the proceeds of production from, or sale of, program properties, Provident would be directly liable.

10. Remuneration of officers and directors:

The Company has eight directors who received fees of $11,145 as directors (June 30, 1977 — $14,885) and eight officers, two of whom were also directors, who received remuneration of $112,265 (June 30, 1977 — $205,155 to eight officers, two of whom were also directors) in their capacity as officers.

11. Earnings per common share:

Basic earnings per common share is based on the weighted average number of common shares outstanding during each period. No material dilution of the results for the six months ended December 31, 1977 would result from the exercise of the employee stock options presently outstanding (Note 7).

Fully diluted earnings per common share for the year ended June 30, 1977 were based on the assumption that the 666,667 shares reserved for future issuance under the terms of the secured convertible income debenture and 13,300 shares with respect to which options were then outstanding under the Incentive Stock Option Plan had been issued at the beginning of the fiscal year. Earnings have been increased by the interest on the income debenture and earnings at 5% have been imputed based on the assumed after-tax interest which could have been earned on the funds received from the exercise of the options.

	Basic earnings per common share	Fully diluted earnings per common share
June 30, 1977:		
Earnings before extraordinary item	$1.415	$1.160
Extraordinary item	0.301	0.227
Net earnings for the year	$1.716	$1.387

Under United States accounting practice, basic and fully diluted earnings per share would not differ materially.

12. Anti-inflation legislation:

The Company's sale of domestic production is not subject to the provisions of the Anti-Inflation Act as the sale of such products is already governed by the Petroleum Administration Act. However, the Anti-Inflation Act does impose certain restrictions with respect to employee and director compensation and dividends. In the opinion of management, the Company has in all material respects complied with the guidelines since their announcement.

13. Quarterly financial data (unaudited):

Summarized quarterly financial data for the six-month period ending December 31, 1977 is as follows:

	Three Months Ended September 30, 1977	Three Months Ended December 31, 1977
	(thousands except for per share amounts)	
Total revenue	$4,670	$5,820
Funds generated from operations before current income taxes	1,672	2,135
Net earnings for the period	685	1,000
Net earnings per share	$ 0.33	$ 0.37

The interim financial information set out in this note has not been subjected to a limited review by the Company's external auditors.

Auditors' Report

DELOITTE, HASKINS & SELLS

Chartered Accountants

700-202 SIXTH AVENUE S.W., CALGARY, ALBERTA T2P 2R9

To the Shareholders of
Canadian Merrill Ltd.:

We have examined the consolidated statement of financial position of Canadian Merrill Ltd. as at December 31, 1977 and the consolidated statements of operations and changes in financial position for the six months ended on that date and have obtained all the information and explanations we have required. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, and according to the best of our information and the explanations given to us and as shown by the books of the company, these consolidated financial statements are properly drawn up so as to exhibit a true and correct view of the state of the affairs of the company as at December 31, 1977 and the results of its operations and the changes in its financial position for the period then ended, in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Deloitte, Haskins & Sells

February 17, 1978

Auditors

Management's Discussion and Analysis of The Summary of Operations

SIX MONTHS DECEMBER 31, 1977 COMPARED TO SIX MONTHS DECEMBER 31, 1976

Production revenue increased by 34.4% due to: (a) higher production of natural gas, up 10.3%; and (b) higher average wellhead prices for natural gas and crude oil of $1.40 per Mcf and $10.69 per barrel, respectively. The higher gas production results primarily from additional gas wells placed on production in the spring of 1977, which affected only the six-month December 31, 1977 operations. Partially offsetting the additional gas production in 1977 were sales restrictions imposed by the gas purchaser as the result of a current market oversupply situation.

Royalties, expressed as a percentage of production revenue, were up slightly to 35.9% from 33.5% as a result of the higher royalty schedule applicable to the increased gas and oil prices.

Production and operating costs were significantly higher in the 1977 period due to a major program of well servicing and maintenance conducted on certain of the Company's producing properties.

General and administrative costs have increased by 42.2% due to the higher payroll and benefit costs related to a significant increase in the Company's management and technical staff, the introduction of a pension plan and improved group insurance plan and higher occupancy costs of the Company's new and expanded office facilities.

Interest expense, in aggregate, has not changed materially for the comparative periods. However, interest expense, excluding the income debenture interest, is up due to the higher level of short and long-term bank indebtedness in 1977 versus 1976. As a result of the conversion by a major shareholder of the Company's $4,000,000 Secured Convertible Income Debenture on October 31, 1977 into common shares of the Company under the terms of the Debenture Agreement, no interest was applicable to the four-month period preceding the date of conversion.

The loss of $178,000 on the translation of U.S. currency into Canadian results from the application of FASB Statement No. 8. No comparable loss exists for the 1976 period.

As the result of the increased level of operating and administrative costs combined with the adverse effect of FASB No. 8, translation losses, pre-tax cash flow increased only 15.1%.

Income taxes, expressed as a percentage of pre-tax income, are materially up to 38.5% from 30.7% due primarily to the increased weighting of disallowed Crown royalties contained in the 1977 operations as compared to 1976 which are not fully compensated for by the federal resource allowance and provincial royalty tax credits and rebates; see Note 6 to the Financial Statements.

Net income before extraordinary items was virtually unchanged at $1,685,000 versus the 1976 results of $1,671,000. However, due to the conversion of the $4,000,000 Income Debenture into 666,667 common shares, as previously discussed, net earnings per the average outstanding number of common shares were down to 70¢ from 81¢ for the comparative period. The 1976 six-month period contained an extraordinary income item, reduction of income taxes of $349,000, with the result that net income for that period was $2,020,000.

JUNE 30, 1977 COMPARED TO JUNE 30, 1976

Revenue, pre-tax cash flow and net income, increased significantly due to: (a) higher production of natural gas and crude oil, up 24.3% and 7.1%, respectively; and (b) higher average wellhead prices for natural gas and crude oil, up 33.8% to $1.16 per Mcf and 5.2% to $9.09 per barrel, respectively.

Higher gas production resulted primarily from new gas wells being placed on production in the spring of 1977 combined with a full year's effect of other new gas production which commenced in early 1976. This result was achieved despite gas sales curtailments in 1977 as a consequence of a market oversupply situation.

General and administrative expenses increased by 31.6% due to the higher payroll and benefit costs associated with an increase in the Company's management and professional staff and the higher occupancy costs of the Company's new and expanded offices.

The loss of $192,000 on the translation of U.S. currency into Canadian results from the application of FASB Statement No. 8, whereby all U.S. dollar long-term debt is converted at the year-end exchange rate into the Canadian equivalent as though the purchase of U.S. funds with Canadian funds would be necessary to retire the debt at that time. To the extent that income from Merrill's U.S. oil and gas production is generated to repay the U.S. dollar debt or that the exchange rate between the respective currencies varies from time to time, continuing gains or losses will be recorded.

Interest charges were, in aggregate, approximately equal to those incurred in 1976 despite a higher average debt outstanding due to the lower effective interest rates applicable throughout all of fiscal 1977.

JUNE 30, 1976 COMPARED TO JUNE 30, 1975

Revenue and net income from oil and gas operations increased significantly as the result of: (a) higher production of natural gas (up 34.6%) due to the effect of a full year of production from the properties purchased from former participants of Provident sponsored drilling fund programs effective January 1, 1975 and further new reserves put into production in early 1976; (b) higher average wellhead prices for natural gas, 86.7¢ for fiscal 1976 versus 41.7¢ for fiscal 1975; and (c) higher crude oil production and average wellhead prices received. Crown and overriding royalties also increased as a percentage of total oil and gas production revenue to 33.5% from 27% for the previous year reflecting the higher provincial Crown royalty scale applicable to higher natural gas prices. Interest costs are double the fiscal 1975 experience reflecting higher average levels of indebtedness throughout 1976 as compared to 1975 as a result of the purchase of producing properties in early 1975, and higher rates of interest.

STOCK PRICE

The following table indicates the quarterly high bid and low bid prices for the common stock of the Company on the Toronto Stock Exchange for the last two years.

	1977		1976	
First Quarter	$15.00	$12.50	$ 6.75	$ 5.25
Second Quarter	15.37	12.87	10.62	6.00
Third Quarter	16.00	13.87	10.75	8.75
Fourth Quarter	16.37	13.50	13.75	9.12

Canadian Merrill Ltd.

Five Year Review

(dollar amounts in thousands except per share amounts)

	Six Months Ended December 31, 1977	Six Months Ended December 31, 1976	Year Ended June 30, 1977	Year Ended June 30, 1976	Year Ended June 30, 1975	Year Ended June 30, 1974
Financial:						
Oil and gas production revenue	$10,432	$ 7,761	$ 16,181	$ 10,382	$ 4,553	$ 2,486
Crown and overriding royalties paid	3,742	2,597	5,486	3,475	1,240	480
	6,690	5,164	10,695	6,907	3,313	2,006
Interest and other income	58	93	150	170	103	115
	6,748	5,257	10,845	7,077	3,416	2,121
Production and operating	1,118	604	1,563	1,012	673	456
General and administrative	923	649	1,477	1,122	788	616
Interest expense	639	510	1,085	1,133	552	464
Interest on income debenture	—	130	260	260	260	87
Mining exploration and overhead	83	57	148	—	—	—
Loss on translation of foreign currency	178	—	192	—	—	—
	2,941	1,950	4,725	3,527	2,273	1,623
Funds generated from operations before income taxes	3,807	3,307	6,120	3,550	1,143	498
Per common share	$ 1.58	$ 1.60	$ 2.95	$ 1.76	$ 0.57	$ 0.25
Depletion and depreciation	1,066	896	1,816	1,195	782	426
Earnings before income taxes	2,741	2,411	4,304	2,355	361	72
Income taxes	1,056	740	1,372	662	161	74
	1,685	1,671	2,932	1,693	200	(2)
Earnings (loss) from discontinued operations	—	—	—	(296)	237	652
Earnings before extraordinary items	1,685	1,671	2,932	1,397	437	650
Per common share	$ 0.70	$ 0.81	$ 1.42	$ 0.69	$ 0.22	$ 0.32
Extraordinary items (net)	—	349	623	590	58	(262)
Net earnings for the period	$ 1,685	$ 2,020	$ 3,555	$ 1,987	$ 495	$ 388
Per common share	$ 0.70	$ 0.98	$ 1.72	$ 0.99	$ 0.25	$ 0.19
Average shares outstanding	2,416,018	2,070,578	2,072,224	2,013,920	2,013,920	2,013,920
Long-term debt	$15,906	$ 11,712	$ 13,847	$ 11,445	$ 14,847	$ 6,827
Capital expenditures	$ 6,551	$ 6,862	$ 11,246	$ 6,447	$ 13,482	$ 2,304
Total capital employed	$41,840	$ 27,973	$ 32,501	$ 24,494	$ 24,734	$ 15,932
Operating:						
Gross production, net before royalties:						
Natural gas						
Total — million cubic feet	6,496	5,891	11,821	9,512	7,068	5,482
Daily average — MMcf.	35.3	32.0	32.4	26.0	19.4	15.0
Oil Production						
Total — barrels	124,454	127,126	240,875	224,831	181,245	204,695
Daily average — bbls.	676	691	660	614	497	561
Gross reserves, net before royalties:						
Natural gas billions of cubic feet	423	n.a.	431	290	257	185
Crude oil thousands of barrels	2,450	n.a.	2,471	2,081	1,538	1,754
Number of net productive wells:						
Gas	130.9	108.5	120.3	107.3	88.2	63.1
Oil	64.9	64.7	64.9	59.9	58.9	51.8
Acreage holdings:						
Gross	655,721	827,670	804,730	879,540	806,037	3,232,219
Net	363,480	379,055	394,249	438,566	362,713	604,747

Canadian Merrill Ltd.

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Suite 2900, Scotia Centre
700 - 2nd Street S.W.
Calgary, Alberta T2P 2W2

Head Office
1203 IBM Building
5 Place Ville Marie
Montreal, Quebec H3B 2H1

Stock Exchange Listings
TORONTO STOCK EXCHANGE
Toronto, Ontario
MONTREAL STOCK EXCHANGE
Montreal, Quebec
AMERICAN STOCK EXCHANGE
New York, New York

Auditors
DELOITTE, HASKINS & SELLS
Chartered Accountants,
Calgary, Alberta

Principal Operating Subsidiaries
PROVIDENT RESOURCES LTD.
Suite 2900, Scotia Centre
700 - 2nd Street S.W.
Calgary, Alberta T2P 2W2

PROVIDENT RESOURCES, INC.
Suite 821, 821 - 17th Street
Denver, Colorado 80202

Transfer Agents & Registrar
CANADA PERMANENT TRUST COMPANY,
Montreal, Quebec
Toronto, Ontario
Calgary, Alberta
THE CANADIAN BANK OF COMMERCE
TRUST COMPANY
New York, New York

Bankers
THE ROYAL BANK OF CANADA
Calgary, Alberta
THE FIRST NATIONAL BANK OF DENVER
Denver, Colorado

Canadian Merrill Ltd.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
For the Six Months Ended December 31, 1975
(Unaudited)
(in Canadian dollars)

Note 1 — Income (Loss) From Discontinued Operations:

Discontinued operations comprise the following: well servicing, oilfield equipment rental and custom milling and mining operations.

Included in the determination of net income (loss) from discontinued operations are the following amounts for the respective periods:

	Dec. 31/75	Dec. 31/74
Revenues from service operations	*$ 2,612,654*	*$3,953,974*
Revenue from custom milling operations	*$ (34,972)*	*$ 180,651*
Employee termination costs	*$ 198,900*	*$ —*
Mining exploration expense	*$ 49,681*	*$ 17,051*
Depreciation and amortization	*$ 195,375*	*$ 366,714*
Interest charges	*$ 98,772*	*$ 98,465*
Income taxes — Current	*$ 94,713*	*$ 17,400*
— Deferred (Recovery)	*$ (207,913)*	*$ 186,481*

Note 2 — Gain on Disposal of Well Servicing and Rental Equipment Assets:

This account is comprised as follows:

Book gain on sale of equipment (including capital gains of $509,356)	*$1,446,367*
(Loss) on disposal of shares of an 80% owned subsidiary	*(60,163)*
	1,386,204
Deduct: Estimated income taxes applicable to net gains, deferred	*596,000*
	790,204
Deduct: Allocation of goodwill attributable to well servicing operations for assets sold	*677,204*
Net gain on disposal of well servicing equipment	*$ 113,000*

It is anticipated that the total sales proceeds for the assets remaining unsold as of December 31, 1975 will be approximately $1,279,000 with a resulting net of tax gain of approximately $42,000 after the allocation of the remaining goodwill of $293,765 attributable to these businesses.

***Note 3** — Certain 1974 figures have been restated to reflect the presentation adopted for the 1975 figures and an adjustment to the provision for current income taxes resulting from the introduction of the Alberta Small Explorer Royalty Tax Credit Plan in December, 1974, retroactive to May 6, 1974.*

CONSOLIDATED STATEMENT OF RETAINED EARNINGS
For the Six Months Ended December 31, 1975
(with the 1974 figures for comparison)

	Six Months to: Dec. 31/75	Dec. 31/74
Retained earnings:		
At beginning of period	$1,081,933	$ 587,381
Add:		
Net Income for the period	450,000	128,395
	1,531,933	715,776
Deduct:		
Special taxes paid on undistributed income of subsidiaries	148,969	—
At end of the period	$1,382,964	$ 715,776

Canadian Merrill Ltd.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION
For the Six Months Ended December 31, 1975
(Unaudited)
(in Canadian dollars)

	Six Months to: Dec. 31/75	Dec. 31/74 (as restated)
Working capital was provided by:		
Operations —		
Funds generated before current income taxes:		
Continuing oil and gas operations	$1,157,000	$ 122,677
Discontinued operations (Note 1)	(96,000)	729,049
	1,061,000	851,726
Less: Current income taxes (recovery)	(178,087)	(60,600)
	1,239,087	912,326
Extraordinary items:		
Sales of investments	149,318	—
Proceeds of disposal of well servicing and rental equipment assets (Note 2)	5,791,472	—
	7,179,877	912,326
New long-term debt	—	1,349,640
Sale of properties and equipment	54,536	299,916
Peru expenditures recovered	—	1,047,388
Other	5,051	4,218
	7,239,464	3,613,488
Working capital was used for:		
Additions to properties and equipment	2,181,416	2,610,848
Peru exploration agreement	—	1,054,439
Reduction of long-term debt	2,348,642	1,084,138
Conditional sales contracts receivable	1,500,000	—
Special taxes paid on undistributed income of subsidiaries	148,969	—
Decrease in deferred production revenue	—	170,568
Advances to drilling fund programs	37,758	186,186
Deferred income taxes reclassified current	21,854	10,000
Purchase of shares of a subsidiary and an affiliate company	20,000	—
Advances (repayments) affiliated companies	(5,051)	28,875
	6,253,588	5,145,054
Increase (Decrease) in Working Capital for the Period	$ 985,876	$(1,531,566)

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Canadian Merrill Ltd.

Interim Report for the Six Months Ended December 31, 1975

Canadian Merrill Ltd.

To the Shareholders:

The Annual General Meeting of Shareholders was held on January 30, 1976 in Montreal. The Directors elected to serve for the ensuing year were Messrs. R. J. Abercrombie, K. S. Dalton, J. Debray, A. M. Doull, V. L. Hawkes, H. ReKunyk, C. K. Taylor, Q.C. and J. M. Thomson, Q.C. Of the three new Directors, Mr. Abercrombie is a Vice-President of Alberta Gas Trunk Line Company Limited; Mr. Taylor is Vice-President, Secretary and General Counsel of Hudson Bay Mining and Smelting Co., Limited and Mr. Thomson is an Associate in the law firm of Milner & Steer.

At the Organization Directors' Meeting following the Annual Meeting, Mr. H. ReKunyk was elected Chairman of the Board and President; Mr. C. W. Templeton, Senior Vice-President; Mr. R. F. Gilmour, Vice-President; Mr. G. B. Padley, Vice-President and Mr. W. C. Mills, Secretary. Price Waterhouse & Co. were reappointed as auditors.

Six Months Review

The comparative figures for the period ended December 31, 1974 included in the Consolidated Statement of Operations and in the Changes in Financial Position have been restated to present separately the results of the continuing oil and gas operations of the Company. The results attributable to the discontinued well servicing, oilfield equipment rental divisions and the custom milling and mining operations for this period in 1974 have been combined and presented in the respective consolidated statements on a net basis.

Gross revenue from oil and gas production increased 183% to $4,117,000 in the 6 months ended December 31, 1975 from $1,454,000 last year. This increase primarily reflects higher gas prices effective on November 1, 1975.

Cash flow from oil and gas operations increased to $1,157,000 at December 31, 1975 from $123,000 last year. The inclusion of net cash flow from the discontinued well servicing, oilfield equipment rental and custom milling operations resulted in a 24% increase in cash flow to $1,061,000 (52.7¢ per share) this year from $852,000 (42.3¢ per share) at December 31, 1974 as shown by the Consolidated Statement of Changes in Financial Position.

Net income for the 6 months to December 31, 1975 increased 250% to $450,000 (22.3¢ per share) from $128,000 (6.4¢ per share) for this period last year.

Effective November 1, 1975, the basic gas price received by your Company increased to an average of 95¢ per thousand cubic feet (Mcf) compared with an average price of 41.7¢ per Mcf received by Merrill in the 1975 fiscal year. A further price increase is anticipated effective July 1, 1976.

Gross production for the first 6 months of the current fiscal year increased to 22.6 million cubic feet of gas per day from 19.4 million cubic feet per day for the 1975 fiscal year. Oil production also increased to 612 barrels per day from 497 barrels per day due to increased production from the Company's Wyoming properties.

During the first 6 months of this fiscal year, the Company participated in drilling 11 exploratory wells and 16 development wells resulting in 12 gas wells in Alberta.

Your Company is currently placing on production additional gas reserves located in the Bolloque, Oyen, Edgerton and Wainwright fields.

Disposal of Well Servicing and Equipment Rental Division

The Company has virtually completed the disposal of its well servicing and equipment rental division assets so that it may direct its future energy and financial resources into the exploration and production segments of the oil and gas industry.

At December 31, 1975, 35 service rigs together with ancillary equipment had been sold for proceeds of $4,567,073.

Effective November 1, 1975, the Company completed the sale of its oilfield equipment rental division assets for $1,453,491 including $229,092 allocated to resale inventories.

The sales completed to date together with the anticipated sale of the remaining well servicing assets will provide aggregate proceeds of approximately $7,300,000 to the Company. These funds will be used to reduce long-term debt and to improve Merrill's working capital position.

Change of Address

Merrill maintains its Head Office in the Province of Quebec in accordance with the terms of its incorporation in that province. In this connection, the Company has recently changed the address of its Head Office to 1203 IBM Building, 5 Place Ville Marie, Montreal, Quebec H3B 2H1.

However, all inquiries from shareholders or those relating to any of Merrill's operations should be directed to its Executive and Business Office located at:

630 IBM Building
606 - 4th Street S.W.
Calgary, Alberta
T2P 1T1
Telephone (403) 263-6653

Outlook

The recent improvement in Merrill's working capital position and the anticipated substantial increases in its future cash flow will enable the Company to expand the development operations on its existing properties and to increase its participation in exploratory prospects offering greater potential returns.

H. ReKunyk

H. REKUNYK,
President.

Calgary, Alberta
February 27, 1976.

Canadian Merrill Ltd.

CONSOLIDATED STATEMENT OF OPERATIONS
For the Six Months Ended December 31, 1975
(Unaudited)
(in Canadian dollars)

	Six Months to: Dec. 31/75	Dec. 31/74 (as restated)
Revenue:		
Gross production income	$4,117,000	$1,454,000
Interest and other income	45,709	31,496
	4,162,709	1,485,496
Costs and expenses:		
Crown and overriding royalties	1,255,902	376,400
Production and operating expenses	500,125	295,100
General and administrative	518,500	364,288
Interest charges	601,182	197,031
Interest on income debenture	130,000	130,000
	3,005,709	1,362,819
Funds generated from continuing oil and gas operations before current income taxes	1,157,000	122,677
Depletion and depreciation	456,369	238,398
Income before income taxes	700,631	(115,721)
Income Taxes:		
Current (Recovery)	(272,800)	(78,000)
Deferred	606,000	94,200
	333,200	16,200
Income (Loss) from continuing oil and gas operations	367,431	(131,921)
Income (Loss) from discontinued operations (Note 1)	(132,431)	192,235
Income before extraordinary items	235,000	60,314
Reduction of income taxes	102,000	68,081
Gain on disposal of well servicing and rental equipment assets (Note 2)	113,000	—
Net Income for the Period	$ 450,000	$ 128,395
Income per common share (Note):		
Before extraordinary items	$ 0.117	$ 0.030
Extraordinary items	0.106	0.034
Income for the Period	$ 0.223	$ 0.064

Note: No material dilution of income per share would result assuming conversion of the income debenture and exercise of outstanding options.

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Interim Report for the Six Months Ended December 31, 1976

Canadian Merrill Ltd.

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Canadian Merrill Ltd.

To the Shareholders:

Gross oil and gas revenues for the six months ended December 31, 1976 increased 89% to $7,854,000 from $4,163,000 last year. Pre-tax cash flow increased 186% to $3,307,000 ($1.60 per share) from $1,157,000 (57¢ per share). Net income after extraordinary items to December 31, 1976 increased 319% to $1,887,000 (91¢ per share) from $450,000 (22¢ per share) in the same period last year.

These increases reflect the current year's higher production rates and product prices compared with the six months ended December 31, 1975.

The Company's working capital decreased by $2,162,000 during this period as a result of 70% of the year's total capital expenditure budget being incurred. It is anticipated that this deficiency will be reversed by year-end.

Merrill's average production rates for the six months to December 31, 1976 increased to 32.1 million cubic feet of gas and 700 barrels of oil per day from averages of 22.6 million cubic feet of gas and 612 barrels of oil in the same period last year. Production for the month of December, 1976 averaged 36.5 million cubic feet of gas and 707 barrels of oil per day.

The Company did not reach its projected production level of 40 million cubic feet of gas per day in January, 1977 due to delays in the completion of the Stanmore gas plant expansion which is now scheduled for March 1.

The Company received an average gas price of $1.10 per thousand cubic feet (Mcf) to date this year compared with an average price of 73¢ per Mcf for the same period in 1975. Effective January 1, 1977, the price of natural gas increased by 10¢ per Mcf in Canada and by 14¢ per Mcf on gas exported to the United States. This will bring the average wellhead price to approximately $1.25 per Mcf. On the same date, the average oil price received in Canada increased from $9.05 per barrel to $9.75 per barrel.

The Company participated in drilling 28 gas wells, 3 oil wells and 6 dry holes in the current fiscal year to date. This includes 4 exploratory gas wells completed in the Rock Canyon area, Colorado.

In the Alberta foothills, the HB Home Blackstone well (Merrill — 1.5% gross overriding royalty interest) is drilling at 10,629 feet and the CanHunter et al Sherman well (Merrill — 5.5% working interest) is at a depth of 11,900 feet.

In January, 1977, the Company purchased interests in 9,600 acres in the Valleyview area, Alberta, and 815 acres in the East Siphon area, British Columbia at Crown sales for $558,363. These lands will be drilled in 1977.

Recent developments in the United States, including the possible de-regulation of gas prices, have confirmed the Company's belief that gas prices will continue to rise toward intrastate levels. These anticipated increases will enhance the value of Merrill's gas reserves in the Rock Canyon area, Colorado. Merrill will continue the development program commenced last year in the Rock Canyon area with the drilling of 6 wells planned for 1977.

Calgary, Alberta
February 10, 1977

H. ReKunyk,
President

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Canadian Merrill Ltd.

CONSOLIDATED STATEMENT OF OPERATIONS

For the Six Months Ended December 31, 1976
(Unaudited)
(in Canadian dollars)

	Six Months to:		Three Months to:	
	Dec. 31/76	Dec. 31/75	Dec. 31/76	Dec. 31/75
		(Restated)		(Restated)
Revenue:				
Oil and gas production revenue	$7,761,366	$4,117,000	$4,135,429	$2,482,912
Interest and other income	92,461	45,709	53,273	17,978
	7,853,827	4,162,709	4,188,702	2,500,890
Costs and Expenses:				
Crown and overriding royalties	2,596,954	1,255,902	1,412,714	806,304
Production and operating	604,087	500,125	332,307	273,427
General and administrative	706,024	518,500	411,777	268,959
Interest charges	509,587	601,182	264,352	303,125
Interest on income debenture	130,000	130,000	65,000	65,000
	4,546,652	3,005,709	2,486,150	1,716,815
Funds generated from continuing oil and gas operations before current income taxes	3,307,175	1,157,000	1,702,552	784,075
Depletion and depreciation	895,871	456,369	484,366	209,552
Income from continuing operations before income taxes	2,411,304	700,631	1,218,186	574,523
Income Taxes:				
Current (royalty credit recoverable)	(521,100)	(272,800)	(278,173)	(189,400)
Deferred	1,376,705	606,000	656,968	443,000
	855,605	333,200	378,795	253,600
Income from continuing oil and gas operations	1,555,699	367,431	839,391	320,923
(Loss) from discontinued operations	—	(51,981)	—	(40,682)
Income before extraordinary items	1,555,699	315,450	839,391	280,241
Reduction of income taxes	331,000	102,000	177,398	79,100
Gain (Loss) on disposal of non-current assets related to discontinued operations	—	32,550	—	(80,794)
Net Income for the Period	$1,886,699	$ 450,000	$1,016,789	$ 278,547
Basic income per common share (Note 2)				
Before extraordinary items	$ 0.751	$ 0.117	$ 0.405	$ 0.138
Extraordinary items	0.160	0.106	0.086	—
Income for the Period	$ 0.911	$ 0.223	$ 0.491	$ 0.138

NOTE (1) The 1975 figures have been restated to reflect service employee termination costs as a charge against the extraordinary gain on disposal of assets rather than the net loss from these discontinued operations, consistent with the treatment adopted for the June 30, 1976 Annual Report.

NOTE (2) Fully diluted income per share assumes the conversion of the income debenture and the exercise of outstanding options. Fully diluted income per share for the six months ended December 31, 1976 would be 64.4¢, 12.1¢ and 76.5¢ respectively for each of the above categories. No material dilution of income per share results after these assumptions for the 1975 period.

Canadian Merrill Ltd.

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

For the Six Months ended December 31, 1976
(Unaudited)
(in Canadian dollars)

	Six Months to: Dec. 31/76	Six Months to: Dec. 31/75 (Restated)	Three Months to: Dec. 31/76	Three Months to: Dec. 31/75 (Restated)
Working capital was provided by:				
Operations —				
Funds generated before current income taxes:				
Continuing oil and gas operations	$ 3,307,175	$ 1,157,000	$ 1,702,552	$ 784,075
Discontinued operations	—	64,900	—	(188,086)
	3,307,175	1,221,900	1,702,552	595,989
Less: Current income taxes — discontinued	—	94,713	—	(15,379)
Royalty credit recoverable	(521,100)	(272,800)	(278,173)	(189,400)
	3,828,275	1,399,987	1,980,725	800,768
Extraordinary Items:				
Sales of investments	10,976	149,318	10,976	50
Net proceeds of disposal of non-current assets related to discontinued operations	—	5,594,230	—	2,635,007
	3,839,251	7,143,535	1,991,701	3,435,825
Issue of share capital	301,246	—	13,746	—
New long-term debt	1,240,000	—	1,240,000	—
Other	291,892	59,587	205,312	55,038
	5,672,389	7,203,122	3,450,759	3,490,863
Working capital was used for:				
Additions to properties and equipment	6,861,500	2,181,416	4,856,181	1,208,399
Reduction of long-term debt	955,465	2,337,460	477,733	1,934,230
Conditional sales contracts receivable	—	1,500,000	—	1,279,000
Special taxes paid on surplus of subsidiaries	—	148,969	—	—
Advances to (collections from) drilling fund programs	17,654	37,758	(8,704)	4,223
Other	—	39,004	—	502
	7,834,619	6,244,607	5,325,210	4,426,354
Increase (Decrease) in Working Capital for the Period	$(2,162,230)	$ 958,515	$(1,874,451)	$ (935,491)

CONSOLIDATED STATEMENT OF RETAINED EARNINGS

For the Six Months Ended December 31, 1976
(Unaudited)
(in Canadian dollars)

	Six Months to: Dec. 31/76	Six Months to: Dec. 31/75	Three Months to: Dec. 31/76	Three Months to: Dec. 31/75
Retained Earnings:				
At beginning of period	$2,920,963	$1,081,933	$3,790,873	$1,104,417
Add — Net income for the period	1,886,699	450,000	1,016,789	278,547
Deduct — Special taxes paid on surplus of subsidiaries	—	148,969	—	—
At end of period	$4,807,662	$1,382,964	$4,807,662	$1,382,964